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EXAMINING THE MARKET POWER AND IMPACT OF PROXY ADVISORY FIRMS

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

JUNE 5, 2013

Printed for the use of the Committee on Financial Services

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81–762 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
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EXAMINING THE MARKET POWER AND IMPACT OF PROXY ADVISORY FIRMS

Wednesday, June 5, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:01 a.m., in room 2128, Rayburn House Office Building, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Bachmann, Grimm, Stivers, Fincher, Mulvaney, Hultgren, Wagner; Sherman, Moore, Scott, Himes, Peters, Sewell, and Kildee.

Ex officio present: Representatives Hensarling and Waters.

Chairman GARRETT. Greetings. Good morning. This hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises is hereby called to order.

Today's hearing is entitled, "Examining the Market Power and Impact of Proxy Advisory Firms." I thank our extended panel who are here with us here this morning, and I thank the Members from both sides, as well.

We will begin, as we always do, with opening statements, and then look to the panel for your wisdom and input.

So at this point, I will yield myself about 9 minutes. I am not sure I will use all of it.

With the 2013 proxy season currently in full swing, today's hearing examines the market power impact of proxy advisory firms and, more broadly, whether the proxy system is working for U.S. companies and their shareholders.

Every year, investors vote over 600 billion shares through the proxy system to elect boards of directors and take other corporate actions, as well. Therefore, an accurate, efficient, and transparent proxy voting system is important to ensuring that our capital markets remain competitive.

While proxy voting can play an important role in promoting good corporate governance and enhancing shareholder values, the current system for distributing proxy materials and voting shares has become so complicated that few outside of the proxy process understand how it actually works, including most retail investors, I would guess.

In addition, corporate proxy disclosures have become more voluminous and complex than ever, and the Dodd-Frank Act and SEC rules have significantly expanded the types of issues now subject

to shareholder vote. As a result, many institutional investors and investment advisory firms have come to rely exclusively on proxy advisory firms to help them determine how to vote their clients' shares on literally thousands of proxy questions companies pose each and every year. And much like the overreliance on credit rating agencies during the financial crisis, the rise of proxy advisory firms over the last decade is attributable in large part to the unintended consequences of government regulation.

Back in 2003, the SEC issued rules requiring mutual funds and their investment advisors to construct policies and procedures reasonably designed to ensure that proxies are voted in their clients' best interest. The next year, however, the SEC staff—rather than the Commission itself—interpreted the rules in a manner that now allows mutual funds and investment advisors to effectively outsource their fiduciary obligation when voting their clients' proxies to supposedly independent proxy advisory firms.

What is the result? Well, as a result of the SEC's actions, proxy advisory firms now wield an enormous amount of influence over shareholder voting here in the United States. Two firms in particular you all know—Institutional Shareholder Services (ISS), and Glass, Lewis & Company—account for around 97 percent of the proxy advisory industry.

Together, these two firms alone are reported to provide voting recommendations to clients controlling between 25 and 50 percent of the typical mid-cap or large-cap company shares. Studies indicate that ISS and Glass Lewis are able to sway at least 20 to 40 percent of shareholder votes, particularly in high-profile corporate elections.

Despite their outside influence, however, proxy advisory firms have no duty to make voting recommendations in the best interest of the shareholders, and they have no financial interest in the companies about which they provide voting advice. It should come as no surprise, then, that proxy advisory firms often make voting recommendations based on one-size-fits-all policies and checklists that fail to take into consideration how voting recommendations affect the actual shareholder value.

In fact, proxy advisory firms have increasingly teamed up with others, such as unions and other activist shareholders, to push a variety of social or political or environmental proposals that are generally immaterial to investors and often reduce shareholder value. For example, one recent study found that the stock market reaction to say-on-pay voting recommendations supported by proxy advisors has actually been statistically negative.

So by exploiting the proxy system to push special interest agendas, proxy advisory firms and activist shareholders have increased the cost of doing business for many public companies and disincentivized private companies from going public—all without a corresponding benefit to the investor returns.

Questions have been raised regarding potential conflicts of interest that proxy advisory firms may face when making voting recommendations, for example, as I alluded to a moment ago, activist shareholders—now some of ISS' and Glass Lewis' biggest clients—which increases the risk that these two firms will favor special in-

terest proposals over those that actually increase or enhance the shareholder values.

With all that said, while there may be concerns regarding the manner in which proxy advisory firms operate, proxy advisory firms still serve a valuable role, helping to promote good corporate governance. These firms should not, however, be enshrined as the sole corporate government standard-setters.

And finally, to the extent that regulatory changes to the proxy voting system are necessary, these changes should be aimed at improving the transparency and efficiency of proxy voting and, most importantly, enhancing shareholder value. That is, after all, the point of good corporate governance.

With that, I will yield back my remaining time, and I now yield 5 minutes to the gentleman from California.

Mr. SHERMAN. Thank you, Mr. Chairman.

I want to thank the ranking member of the full committee for asking me to sit in for the ranking member of this subcommittee, who is attending the funeral of our esteemed colleague, Senator Lautenberg; she was a close personal friend of the Senator.

We once had a competition in this world between capitalism and communism. The new competition is between free market capitalism on the one hand and crony capitalism on the other.

The advocates of crony capitalism say that boards should be in total control of their corporations, a small group of people should control hundreds of billions of dollars, and shareholders should be frozen out of the decision-making process and given as little information as possible, as well as be deprived of any advice that would help them question the inside management.

Those who believe in free market capitalism believe that shareholders should be in control of the corporation and they need information, advice, voting, and freedom from frivolous lawsuits. Yet those trying to protect inside power have denied them all of those things.

As to information, we are told that shareholders can't know about blood diamonds. They can't know about secret political contributions because they are crazy if they want to make their investment decisions or their proxy decisions based on those decisions.

Investors are not only told that they will be deprived of the information to make the decision; they are told they are crazy for even wanting to make that decision.

This hearing is about depriving them of the advice. No one in the corporate world has tried to deprive pension plans and investors of all kinds of advice.

As a matter of fact, I have never met somebody on Wall Street who wasn't talking to me about how to sell advice to CalPERS. Yet in this one circumstance, all of a sudden they should not be allowed to get the advice they want, as if these are babes in the woods rather than the epitome of sophisticated investors.

Then, we see a corporate world that has for many decades united behind the lowest common denominator of shareholder rights and corporate law. The rule is that whatever State can have the most pro-management, anti-shareholder corporate law will attract—will become the home domicile of major corporations.

If we cared about shareholders we should be setting the highest possible corporate standards for all—and shareholder rights for all publicly traded companies instead of saying, well, will Delaware or Nevada be the home of those corporations trying to institutionalize crony capitalism?

Finally—and this is truly bizarre—the corporate world formed an alliance with plaintiffs' trial lawyers to try to terrorize or prevent pension plans from divesting from Iran and use their corporate power in this very committee to hold up until a few years ago a bill that simply allowed pension plans to divest from those companies investing in Iran, because depriving shareholders of their right to divest and thereby influence management was thought to be an intrusion on the power of boards.

It is about time for this committee to come out on the side of free market capitalism, of making sure that shareholders are given the information shareholders want, not called crazy because they care about jobs, the environment, preventing terrorism, or preventing secret political contributions. It is time that those investors get the advice. It is time that they have all the protections that a well-drafted corporate statute can provide.

Instead, we are here focusing on the tiny bit of Wall Street advisors that habitually question inside management. That is not the role of this committee.

I know it is easier to protect those who currently control corporations and therefore have power here in Washington, but those of us who believe in free market capitalism should be protecting shareholder rights, and that includes shareholders being able to get the advice they want. And no one here is for depriving them of any other kind of advice except to crack down on those who advise them on how to cast their votes to assure that we have jobs, open elections, and try to do something about Iran and other sources of terrorism.

With that, I yield back.

Chairman GARRETT. I am very pleased to hear that the gentleman from California is all about free market capitalism, and I look forward to the hearing today when we look to provide that through transparency and the ending of conflict of interests with regard to proxy advisors.

Mr. SHERMAN. Mr. Chairman, I would like unanimous consent to enter into the record the statement of the Council of Institutional Investors.

Chairman GARRETT. Without objection, it is so ordered.

And I also look forward to the gentleman working with us outside of this issue to end crony capitalism and realign for free market capitalism and GSE reform, as well, so we can be on the same page on these things.

With that, I yield to the gentleman from Virginia for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Mr. Chairman, thank you for holding today's subcommittee hearing to examine the market power and impact of proxy advisory firms. As proxy advisory firms continue to have an increasingly powerful role in corporate governance, it is important that this committee conduct the proper oversight to ensure that these enti-

ties are working within the appropriate framework that leads to best practices in corporate governance.

As an enormous market share is controlled by two proxy advisory firms, there must be sufficient transparency and accountability. A lack of these critical elements could lead to poor decisions that neither promote good corporate governance nor increase shareholder value.

Additionally, as the SEC has acknowledged, conflicts of interest may arise when proxy advisory firms both provide voting recommendations for shareholder votes and simultaneously offer consulting services to the same company. An appropriate level of oversight, transparency, and accountability will ensure that that investors will be protected and it will strengthen corporate governance.

I would like to thank our distinguished witnesses for appearing today before our subcommittee. I look forward to hearing your testimony.

Thank you, Mr. Chairman. I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back the balance of his time—an extra 1 minute.

And with that, we look to Mr. Scott for 3 minutes.

Mr. SCOTT. Thank you very much.

This is, indeed, an important, important hearing. Two issues certainly matter, I think, very much here: there are reasons why we have Dodd-Frank; and there are reasons why we have responded. From Enron to WorldCom to the 2008 financial crisis to the failure of MF Global, there are numerous examples—notable examples—of failures in corporate governance in recent years.

And I am interested in finding out why only two companies handle 97 percent of this market. I think we need to get a good answer to that. Maybe there is a really good answer for it. But certainly, it is a very important question.

With the 2013 proxy season under way, this hearing is quite timely, if not overdue. Proxy votes are currently taking place by institutional investors who typically own securities positions in a large number of public companies. These votes taking place are on matters such as director elections, consideration of management and shareholder proposals, and are also relevant to many of the delineated goals, as I stated before, of Dodd-Frank in response to the financial crisis.

These can include issues such as: say on pay—which is very important—which is a nonbinding vote on executive compensation practices required under Dodd-Frank; splitting the role of CEO and chairman of the board at a public company; issues regarding employee nondiscrimination policies; or other corporate responsibility measures, including environmental practices.

We must also recognize the possibility of, indeed, conflicts of interest, especially in a market as highly concentrated as proxy advisory, with the two largest firms, again as I said, dominating as much as 97 percent of that market—ISS and Glass Lewis.

As I said, this is a great concern. Some proxy advisory firms also provide consulting services to issuers on corporate governance or executive compensation. A 2010 SEC concept release also noted the potential of conflicts of interests of such firms and the criticism with regards to lack of accuracy and transparency in firms formu-

lating voting recommendation. Yet, the SEC has not taken further action on this.

So as we go forward to address the many regulatory issues raised by the directory of Dodd-Frank, we must balance concerns on behalf of the consumer, the user, our constituents, with the concerns raised by America's public companies, many of whom also are run by our constituents and have stakes in our communities. What policies, for example, or procedures do proxy advisory firms use, if any, to ensure that their recommendations are independent and are not influenced by any consulting fees that they receive from issuers?

I think the American public is very interested in this issue today, and I look forward to getting some very good answers to these questions that I have raised.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back. Actually, he doesn't yield back; he went over.

Is there anyone else?

Mr. SCOTT. Thank you very much and I do yield—

Chairman GARRETT. Ms. Moore is recognized for 2 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman and Mr. Ranking Member, for holding this hearing. I am eager to hear from our witnesses on proxy advisory firms, especially the increasingly important role they play in concentration in the industry.

I want to discuss proxy access more conceptually and restate my support for Section 971 of Dodd-Frank. This is an area that has elicited considerable academic work and debate.

Speaking to the Practicing Law Institute in 2009, then-SEC Chairman Schapiro said of shareholder access, "Corporate governance, after all, is about maintaining an appropriate level of accountability to shareholders by directors whom shareholders elect, and by managers who directors elect."

Chairman Schapiro went on regarding the election of board of directors, "I believe that the most effective means of promoting accountability in corporations is to make shareholders' votes both meaningful and fully exercised. However, in most cases today shareholders have no choice in whom to vote for."

Congress agreed, and included Section 971 in Dodd-Frank. The State of Wisconsin Investment Board (SWIB) simply states that SWIB encourages companies to "establish reasonable conditions and procedures for shareholders to nominate director candidates to the company's proxy and ballot." I agree with that.

One argument of opponents of Section 971-type proxy rules is that high-quality directors may be less willing to serve on boards if they face competition from shareholder-sponsored candidates. It is a silly and offensive argument.

In an age when we tell college kids that they have to compete globally to get a job in corporations, and tell workers that they have to compete to keep their jobs in these corporations, why should directors of the corporations mysteriously be shielded from competition, especially from challenges from the shareholders they should serve? To hear some people tell it, Section 971 aids barbarians at the gate. In reality, it is a measured proposal to enhance corporate governance and accountability.

And I yield back.

Chairman GARRETT. The gentlelady yields back.

We now turn to the panel. And again, I welcome the entire panel.

Some of you have been here before. For those who have not, you will all be recognized for 5 minutes, and the little lights in front of you will be green when you begin; yellow at one minute remaining; and red when your time us up.

Also, your entire written statements will be made a part of the record, so we will look to you to summarize in your 5 minutes.

So with that, again, I welcome the panel. And we will turn first to Mr. Pitt representing the U.S. Chamber of Commerce.

Welcome to the panel. You are recognized for 5 minutes.

STATEMENT OF THE HONORABLE HARVEY L. PITT, FOUNDER AND CHIEF EXECUTIVE OFFICER, KALORAMA PARTNERS, LLC, ON BEHALF OF THE U.S. CHAMBER OF COMMERCE

Mr. PITT. Thank you, Mr. Chairman. It is a pleasure to be back here.

Chairman Garrett, Representative Sherman, and members of the subcommittee, I am pleased to participate in these important hearings representing the U.S. Chamber of Commerce to discuss the extensive but unfettered influence that proxy advisory firms currently wield over corporate governance in the United States.

As you have requested, I will not repeat the Chamber's detailed written statement. Instead, I would like to briefly highlight 5 points for your consideration.

First, effective and transparent corporate governance systems that encourage meaningful shareholder communications are critical if public companies are to thrive. Informed and transparent proxy advice can promote effective corporate governance, but only if transparency exists throughout the proxy advisory process, and the advice provided directly correlates to and is solely motivated by advancing investors' economic interests. Sadly, these two essential components of proxy advice have been lacking for some time.

Second, as has already been observed, two firms—ISS and Glass Lewis—control 97 percent of the proxy advisory business and dominate the industry. Together, they effectively can influence nearly 40 percent of the votes cast on corporate proxy issues, making them de facto arbiters of U.S. corporate governance.

Third, these firms advocate governance standards to U.S. public companies but they do not practice what they preach. Serious conflicts permeate their activities, posing glaring hazards to shareholder interests. They are powerful but unregulated and they cavalierly refuse to formulate and follow ethical standards of their own, render their advice transparently, accept accountability for advocated standards, and assume responsibility to avoid factual errors and shoulder the burden to rectify the mistakes that they make.

This lack of an operable framework for those exercising such a significant impact on our economic growth is wholly unprecedented in our society. Indeed, 2 weeks ago ISS settled serious SEC charges stemming from its failure to establish and enforce appropriate written policies.

Fourth, significant economic consequences flow from proxy advisory firms' unfettered power and lack of fidelity to important ethical and fiduciary precepts, something that has been recognized

both here and abroad. Although U.S. regulators have not fulfilled promises to address these issues, Canadian and European regulators, among others, are speaking out.

Fifth, the answer to these concerns is not more regulation, but rather a collaborative public-private effort to identify core principles and best practices for the proxy advisory industry. In March, the Chamber published best practices and core principles which provides a crucial foundation for successfully delineating standards for the industry to embrace and follow.

What is essential is for responsible voices—this subcommittee, the SEC, institutional investors, public companies, and proxy advisory firms—to lend support to the effort to promulgate and apply effective standards.

Mr. Chairman, members of the subcommittee, it is my hope and strong recommendation that these hearings result in a serious commitment to achieve those goals. Thank you.

[The prepared statement of Mr. Pitt can be found on page 182 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Next, from the Center on Executive Compensation, Mr. Bartl.

STATEMENT OF TIMOTHY J. BARTL, PRESIDENT, CENTER ON EXECUTIVE COMPENSATION

Mr. BARTL. Thank you, Mr. Chairman.

Chairman Garrett, Representative Sherman, and members of the subcommittee, my name is Tim Bartl, and on behalf of the Center on Executive Compensation, I am pleased to present our views on this very important topic. My comments today are based in part on our paper, "A Call for Change in the Proxy Advisory Industry Status Quo," and I would ask that a copy of that be submitted for the record.

Chairman GARRETT. Without objection it is so ordered.

Mr. BARTL. By way of background, the Center is a research and advocacy organization. We are a division of HR Policy Association, that represents the senior HR officers of over 340 large companies, and the Center's subscribing members are across industry group of the association.

Mr. Chairman, today I would like to focus on four points, if I may: the role of proxy advisory firms; their influence over company votes and practices; the impact, as Chairman Pitt talked about, of conflicts of interest and inaccuracies; and an example of the importance of oversight, both regulatory and legislative, in procuring some of the issues changes we are talking about today.

As you have heard both from members of the subcommittee and from Chairman Pitt, proxy advisors fill an important role regarding helping institutional investors fulfill their proxy voting duties, but the speed with which the advisors must analyze proxies leads to a check-the-box mentality driven in part by the desire to present investors with a uniform, condensed version of corporate pay disclosures, even though pay programs are individualized, complex, and lengthy. This can lead to errors, inaccuracies, or questionable characterizations.

And in part, the irony is that the regulatory regime effectively makes each issuer responsible, at least in part, for ensuring the ac-

curacy of its proxy advisory firm reports even though the advisors are the experts. This calls into question the legitimacy of the current model.

So as we look at the influence that the proxy advisors wield—we heard members of the subcommittee talk about some of the academic research, which is all in our written testimony. But the Center data for the 2013 proxy season gives a good illustration, talking about ISS recommendations against say on pay for S&P 500 companies. If you received an "against" recommendation, you got an average of 64 percent support for your say-on-pay vote, compared to about 93 percent if you got a "for" recommendation.

And despite this influence, proxy advisory firms have no economic interest in the companies for which they are giving the recommendations. As one company told us, "It feels like we are giving power over the board to a consultant without a horse in the race."

As we also talk about in our written testimony, proxy advisory firms also influence company pay policies, and when we researched this among our subscribers we found that about 54 percent said that they had changed a pay practice, policy, or plan primarily to meet a proxy advisory firm's standard.

Let me talk for just a second about conflicts of interest and inaccuracies or errors. The practice that ISS practices of providing consulting services to corporate issuers on one side while providing impartial—or so-called impartial—recommendations to issuers and investors on the other is a conflict that we find very troubling because it creates the perception that there is an advantage to taking up the consulting.

In addition, the consulting of ISS with investor clients that are shareholder proponents also creates the perception that ISS may favor those resolutions. And we believe that both practices should be prohibited.

With respect to inaccuracies, there is an example in our testimony, and I would urge you to take a look at it, with respect to Eagle Bancorp, but about 53 percent of Center and HR Policy members said in the survey that a proxy advisory firm had made one or more mistakes in a final report during our research of this.

Mr. Chairman, let me conclude by talking about the sentinel effect of oversight, and this harkens back to 2012. Again, it deals with ISS, the largest firm, which had adopted a new practice—a new methodology for determining peer groups. And the reason that peer groups are important in pay disclosures is the linkage between peers and pay-for-performance. If the peer group is wrong, the connection between pay and performance is likely not to be seen.

And when the methodology was put out, about 23 of 45 S&P 500 companies filed supplemental filings with the SEC saying that peer groups were a problem. This gained the attention of the SEC. And even in conversations with investors, they raised the issue and said they were going to raise it with ISS.

All of this attention, in conjunction with popular press attention, led by early summer for ISS to say, "We are going to reexamine this." They looked at it, and they changed it. We have even seen some of the salient effect since then on greater engagement with us.

And so with that, Mr. Chairman, thanks again for allowing us to testify, and I look forward to answering any questions you may have.

[The prepared statement of Mr. Bartl can be found on page 38 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Next, Mr. Holch, the executive director of the Shareholders Communications Coalition.

You are recognized for 5 minutes.

STATEMENT OF NIELS HOLCH, EXECUTIVE DIRECTOR, SHAREHOLDER COMMUNICATIONS COALITION

Mr. HOLCH. Thank you, Mr. Chairman.

Chairman Garrett, Representative Sherman, and members of the subcommittee, my name is Niels Holch, and I am the executive director of the Shareholder Communications Coalition. The Coalition is comprised of the Business Roundtable, the National Investor Relations Institute, and the Society of Corporate Secretaries. The Coalition was established in 2005 after the Business Roundtable filed a petition for rulemaking with the SEC, urging the agency to conduct a comprehensive evaluation of the U.S. proxy system.

Many of the current SEC shareholder communications and proxy voting rules were adopted more than 25 years ago in 1985 and remain unchanged. These SEC rules were promulgated during a period when most annual meetings were routine and very few matters were contested. They were also developed at a time when technology was not nearly as advanced as it is today.

Just for perspective, these SEC rules were adopted when Ronald Reagan was starting his second term of office, the Dow Jones Industrial average was at 1,500 instead of 15,000, and Microsoft was still publishing software using its DOS operating system.

After decades of inaction, the SEC began to tackle this problem in July of 2010, when it released for public comment a concept release describing concerns about the current proxy process and discussing possible regulatory solutions. Unfortunately, another 3 years has now passed, and the SEC has not taken any action on its concept release.

Let me now provide you with a brief summary of how the current proxy system is structured and why the Coalition believes reforms are essential; 70 to 80 percent of all public company shares in the United States are held in street name, meaning in the name of a broker or a bank rather than its customers, who are referred to as "beneficial owners."

Under SEC rules, brokers and banks are responsible for distributing shareholder meeting materials provided by companies to their beneficial owners and processing their proxy voting instructions. Changes in corporate governance practices have accelerated the need for public companies to communicate more frequently and on a more time-sensitive basis with their shareholders.

However, this is very difficult to accomplish under a system that is controlled by the brokers and the banks. Additionally, SEC rules classify investors as either "objecting beneficial owners," called OBOs, or "nonobjecting beneficial owners," called NOBOs. The public companies represented by the Coalition have one overriding goal

in this area: We want to know who our shareholders are, and we would like to be able to communicate with them directly.

For these reasons, the Coalition supports the elimination of the NOBO–OBO classification rule. This would give public companies access to contact information for their beneficial owners and permit direct communications with them. Once public companies have access to shareholder information, they could assume responsibility for distributing proxy materials directly, making the process more efficient and promoting open communications.

The proxy voting system also needs to be addressed. Reports in the news media of voting miscounts and delays in determining election results have raised questions about the integrity of the voting process. Proxy voting should be fully transparent and verifiable, starting with a list of eligible voters for a shareholder meeting and ending with the final tabulation of the votes cast at that shareholder meeting.

Public companies are also concerned about the role and activities of private firms providing proxy advisory services to institutional investors. Proxy advisory firms should be subject to more robust oversight by the SEC.

For example, the current exemption from the proxy rules that these firms enjoy should be conditioned on their meeting certain minimum requirements governing their activities. The SEC should also require registration of all proxy advisory firms under the Investment Advisors Act. Additionally, the SEC and the Department of Labor should review their existing rules and interpretations to make sure that institutional investors are complying with their fiduciary duties by exercising sufficient oversight over their use of proxy advisory services.

As noted earlier, it has been more than 25 years since the SEC's shareholder communications and proxy voting rules have been updated. The Coalition urges this subcommittee to request that the SEC turn its attention to addressing the issues raised in its 2010 concept release.

Thank you.

[The prepared statement of Mr. Holch can be found on page 150 of the appendix.]

Chairman GARRETT. Thank you.

Next, Mr. McCauley, from the Florida State Board of Administration.

Welcome. You are recognized for 5 minutes.

STATEMENT OF MICHAEL P. McCAULEY, SENIOR OFFICER, INVESTMENT PROGRAMS AND GOVERNANCE, FLORIDA STATE BOARD OF ADMINISTRATION (SBA)

Mr. MCCAULEY. Thank you.

Chairman Garrett, Representative Sherman, and members of the subcommittee, good morning. I am Michael McCauley, senior officer with the Florida State Board of Administration. I am pleased to appear before you today on behalf of the State Board of Administration.

My testimony includes a brief overview of the State Board of Administration and its investment approach followed by a discussion of our proxy voting process and procedures and our use of proxy ad-

visors to assist the SBA in fulfilling its proxy voting obligations. I will also discuss some proposed reforms that will make proxy advisors more transparent to the market and more accountable to their clients.

The Florida State Board of Administration, or SBA, manages more than 30 separate investment mandates and trust funds, some established as direct requirements of Florida law and others developed as client-initiated trust arrangements. In total, the Florida SBA manages approximately $170 billion in assets, and under Florida law, the SBA manages the funds under its care according to fiduciary standards similar to those of other public and private pension and retirement plans.

The SBA must act in the best interest of the fund beneficiaries. This standard encompasses all activities of the SBA, including the voting of all proxies held in funds under SBA management.

In Fiscal Year 2012, the SBA executed votes on thousands of public companies—approaching 10,000; it was approximately 9,500 individual meetings. The SBA makes all proxy voting decisions independently, and to ensure that the SBA meets its fiduciary obligations, it established the Corporate Governance and Proxy Voting Oversight Group, or the Proxy Committee, as one element in an overall enterprise risk management program.

SBA voting policies are based both on market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. During 2012, the SBA issued guidelines for more than 350 typical voting issues and voted at least 80 percent of these issues on a case-by-case basis following a company-specific assessment.

To supplement its own proxy voting research, the SBA purchases research and voting advice from several outside firms—principally the leading proxy advisory and corporate governance firms. When making voting decisions, the SBA considers the research and recommendations provided by advisors along with other relevant facts and research, as well as the SBA's own proxy voting guidelines.

But the SBA makes voting decisions independently and in what it considers to be the best interests of the beneficiaries of the funds it manages. Proxy advisor and governance research firm recommendations inform but they do not determine how the State Board of Administration votes, and they do not have a disproportionate effect on SBA voting decisions.

In Fiscal Year 2012, again, the votes that the SBA executed correlated with the recommendations of one single proxy advisor firm 67 percent of the time. Other historical reviews of SBA voting correlations have shown both lower and higher correlations with individual external proxy advisor recommendations, and that has been dependent on both the time period that was under study as well as the specific voting categories that were in question.

While the SBA acknowledges the valuable role that proxy advisors play in providing pensions funds with informative, accurate research on matters that are put before shareowners for a vote, we believe proxy advisory firms should provide clients with substantive rationales for vote recommendations, minimize conflicts of interest, and have appropriate oversight. Toward that end, the SBA

believes that proxy advisors should register as investment advisors under the Investment Advisors Act of 1940.

Registration would establish important duties and standards of care that proxy advisors must uphold when advising institutional investors. And additionally, the mandatory disclosures would expose conflicts of interest and how they are managed and establish liability for firms that withhold information about such conflicts.

Mandatory disclosure should also include material information regarding the process and methodology by which the firms make their recommendations, aimed at allowing all stakeholders to fully understand how an individual proxy advisor develops those voting recommendations. This would make advisor recommendations more valuable to institutional investor clients and more transparent to other market participants, including corporations. In this way, registration would complement the aims of existing securities regulation, which seeks to establish full disclosure of all material information.

Thank you, Mr. Chairman, for inviting me to participate in the hearing, and I look forward to the opportunity to answer any questions.

[The prepared statement of Mr. McCauley can be found on page 162 of the appendix.]

Chairman GARRETT. And I thank you.

Next, Mr. Morgan, from the National Investors Relations Institute (NIRI).

STATEMENT OF JEFFREY D. MORGAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL INVESTOR RELATIONS INSTITUTE (NIRI)

Mr. MORGAN. Thank you, Chairman Garrett, Representative Sherman, and members of the subcommittee for holding this hearing and for inviting the National Investor Relations Institute, or NIRI, to participate.

My name is Jeff Morgan, and I am president and CEO of NIRI. Founded in 1969, NIRI is the largest professional investor relations association in the world, with more than 3,300 members representing over 1,600 publicly traded companies and $9 trillion in stock market capitalization.

My written testimony focuses on the two topics of this hearing: proxy advisors; and improving communications and engagement between public companies and shareholders. I will focus my verbal comments on the communications aspect.

An open channel of two-way communications is needed for any business between its owners and its investors. Businesses have an obligation to keep their owners informed on business operations, financial results, and other material information. Owners have an obligation to ensure management is operating within expected guidelines and to offer their input on key decisions.

In all cases, I think most would agree that two-way communications is much less effective when each party doesn't know who the other party is. That is the situation with public companies in the United States today and one of the many challenges we have with our capital markets and proxy system as they have evolved over the last several decades.

Shareholders know they own stock or equity in a company, but the company has limited ability to know who the shareowners of the company are at any point. Ultimately, better transparency in shareholder ownership would improve the two-way dialogue of companies and shareholders, creating healthier U.S. capital markets.

While companies operate under a host of regulations, there are few regulations to allow for shareholder information to be provided to the company to ensure there is a healthy flow of information and dialogue from company to shareholders.

One of the few mechanisms is the choice of shareholders to be registered or to hold shares in street name. Registered shareholders are those who directly register with the issuer or publicly traded company, thus enabling the company to know the identity of the shareholder, as well as providing for the free flow of information between the company and the shareholder.

Street name shareholders are those who use a broker or bank to hold the shares on their behalf. While the street name shareholder is the beneficial shareholder, there is no direct registration with the company, and consequently, the company doesn't necessarily know the shareholder's identity.

Prior to the 1970s, estimates are that approximately 75 to 80 percent of shares were registered and about 20 to 25 percent were held in street name. Today, the opposite is true, with about 80 percent of shares in street name and 20 percent registered with the company.

As our capital markets have evolved, companies have lost the direct linkage with their shareholders. The only report that provides some insight for a company into its larger shareholders is SEC filing Form 13F. While not specifically designed to help companies know who their largest shareholders are, Congress established a reporting regime in the late 1970s to provide public reporting by certain larger investment managers of their equity position.

Every institutional manager who exercises investment discretion having an aggregate market value of at least $100 million on the last trading day of the month must file a Form 13F. Managers must file these reports with the SEC within 45 days after the last day of each quarter.

The practical effect of this rule is that an investment manager may buy shares on January 2nd and not have to report that holding publicly until May 15th, more than 19 weeks after the transaction. This is hardly a productive way for issuers to know their shareholders.

Recently, the NYSE, the Society of Corporate Secretaries, and NIRI submitted a petition to the SEC to reduce the reporting delay from 45 days down to 2 days. As part of Dodd-Frank, Congress mandated the SEC consider similar rules for short selling, requiring disclosure every 30 days. So we believe an evaluation of the entire equity ownership disclosure process as part of the evaluation of proxy mechanics and proxy advisors makes sense.

With the increasing involvement of shareholders in corporate governance matters, it is clear that improvements to our system for linking shareholders and companies are needed. Public companies would welcome it, and this would dramatically increase the ability of companies to engage with shareholders.

Action in this area, combined with an examination of our 20-plus-year-old proxy system, including a focus on the proxy advisory service area, would go a long way to enhancing our proxy and shareholder communications process in the United States.

In conclusion, thank you for the opportunity to testify, and I look forward to your questions.

[The prepared statement of Mr. Morgan can be found on page 169 of the appendix.]

Chairman GARRETT. And I thank you for your testimony.

Next up, from the Society of Corporate Secretaries & Governance Professionals, Ms. Stuckey is recognized for 5 minutes.

STATEMENT OF DARLA C. STUCKEY, SENIOR VICE PRESIDENT, POLICY & ADVOCACY, SOCIETY OF CORPORATE SECRETARIES & GOVERNANCE PROFESSIONALS

Ms. STUCKEY. Thank you, Chairman Garrett, Representative Sherman, and members of the subcommittee.

I am Darla Stuckey, senior vice president at the Society of Corporate Secretaries & Governance Professionals. We have 3,100 members representing about 1,200 public companies and about over half of those are small-and mid-caps.

Reading proxy statements is time-consuming. Few investment managers will allocate capital to voting decisions that they believe will not generate a return on investment. In short, proxy voting, other than in a "bet the farm" type scenario, is simply not worth the cost.

So outsourcing to proxy advisory firms is pragmatic, but many investors use their reports like CliffsNotes: They read the summary report but not the proxy. Some don't even read the report; they just take the vote recommendation automatically.

But proxy statements are subject to full 1934 Act liability and are filed with the SEC. Proxy advisory firm reports are not, but should be.

My testimony will cover the proxy advisory firm influence and problems we have with their policies, conflicts, and errors.

Due to the sheer volume of companies, proxy firm reports are based on one-size-fits-all policies. This is a problem simply because companies are not the same.

Voting decisions and routine elections are even more important now than they have been with the advent of say-on-pay and majority vote for directors. Companies of all sizes now must navigate proxy advisory firm policies and guidelines.

As you have heard, they control at least 20 percent and maybe upwards of 40 percent of the vote. This is much larger than the Schedule 13D threshold and even larger than the 10 percent affiliate status threshold, both of which require public reporting.

In 2009 and 2010, IBM stated that the voting block that ISS controlled had more influence than its largest shareholder. This is the case even though the proxy advisory firms have no economic stake in the company and have not made meaningful disclosure about their power, conflicts of interests, or controls.

Proxy firm voting policies are also not transparent. We don't know how they are developed. Although ISS provides both issuers

and investors with an opportunity to take their survey, the questions are often skewed and biased towards a narrow agenda.

We don't know if the issuer's voice counts, and the number of institutions who take the survey is very small. ISS reported 201 responses in 2010, representing only 15 percent of its institutional clients—even fewer since. So consider that 15 percent of ISS' clients create policies that influence as much as 20 percent of the vote of every public company.

They also influence corporate behavior. Just the threat of an "against" vote causes boards to change their practices to satisfy the one-size-fits-all guidelines. "What will ISS say?" is regularly asked in the board rooms.

Proxy advisory firms are also subject to conflicts, which you have heard, and which are discussed in my written testimony.

I will explain one. Here is the story: One company member received a call from a sales representative from Equilar, a company working with Glass Lewis, 2 days after Glass Lewis recommended against their say-on-pay proposal. The rep wanted to sell the company a service that would shed light on the recommendation.

The society member asked about the basis for the CEO compensation number that had been used because its CEO had changed in 2012 and it looked like Glass Lewis had used a composite of the former CEO's compensation and the new CEO comp. But even still, the number was 45 percent higher than what was in the summary comp table.

The member asked for an explanation, but the sales representative was unwilling to discuss it unless the company subscribed to their service, which was about $30,000. Indeed.

And lack of access to reports is at the heart of the larger problem of mistakes. Until recently, a company could get its Glass Lewis report from its proxy solicitor or a law firm, but no longer.

Instead, Glass Lewis will sell issuers a copy of the report for $5,000 or they can buy the $30,000 service I mentioned. So if an issuer wants to see the facts given to its investors, their only choice is to pay for the report.

At the very least, proxy recommendation reports should be provided to all issuers in advance of publication, free of charge, to enable the issuer to check the factual accuracy of the report, because votes that are not based on facts are not informed votes and we don't believe an institution can satisfy its fiduciary duties by relying on something that is not accurate or that it doesn't know is accurate.

Other problems: Aside from conflicts, the reports can contain mistakes. One example relates to ISS' peer group selection methodology. A small-cap member wrote to me yesterday—somebody with no access to the report in advance—telling us that last week, ISS also recommended against its say-on-pay proposal.

Here is what he described: The ISS peer group bears almost no relationship to our industry. We are an e-mail data security company. We sell B-to-B. They have designated as peers consumer-oriented online media companies, personal dating sites, online games, et cetera, that have nothing to do with our industry. We don't compete with these companies for talent and we have been consistently

profitable for the measurement period, whereas most of the companies to which they compare us have not been.

In sum, both investment advisors and proxy advisory firms must have an obligation to ensure that vote recommendations are based on accurate facts and are in the best economic interests of the shareholders.

Thank you.

[The prepared statement of Ms. Stuckey can be found on page 222 of the appendix.]

Chairman GARRETT. Thank you.

And having the final word on the topic—well, maybe not—Mr. Turner, you are recognized for 5 minutes.

STATEMENT OF LYNN E. TURNER, MANAGING DIRECTOR, LITINOMICS

Mr. TURNER. Thank you, Chairman Garrett. It is indeed an honor to be invited back again to testify before the committee, and I would like to thank you and Representative Sherman.

I would like to make a few key points today, and my points will be based upon my past experience: I have been a member of the corporate boards of public companies which were subject to the recommendations of the proxy voting firms; I have been on the board of two institutional investors who did the proxy voting; I have been a financial executive, vice president, in a large international semiconductor company; I was a former regulator at the SEC; and I also was a senior executive and head of research at Glass Lewis during its initial formative years, from 2003 to 2007.

First, let me note that proxy voting is an important right to the owners of public companies. Proxy voting provides investors with a very useful market-based mechanism with which to establish the accountability of both the board of directors and management, which is what makes our capital market system work.

Second, many investors and their asset managers take this responsibility very seriously. If you look at the Web sites of the largest public pension funds and the 15 largest money managers, such as Fidelity, Vanguard, and Blackrock, you will find they all have their own custom designed proxy voting guidelines, as well as staff dedicated to proxy voting. These custom guidelines are similar at times to those of the two proxy advisory firms on issues, but this is because investors do have some common views on what is good governance in the corporate community.

Third, asset managers may buy research from the proxy voting services to gather useful information and assist with their analysis of the issues. However, it is not uncommon that they will vote differently than ISS or Glass Lewis and their recommendations and often vote with management. And certainly, one would think that buying of such research to add to one's available information about the issue should not be criticized in the context of trying to be fully informed about an issue.

Fourth, in today's global markets an investor asset manager is going to invest in dozens of capital markets around the globe. At COPERA, we invest in 7,000 to 8,000 companies. A proxy advisory firm like Glass Lewis or ISS may issue recommendations on 20,000 to 40,000 proxies a year around the globe.

Clearly, the mutual funds and the pension funds don't have the staff to go through all of those. It would be cost-prohibitive. It would take well over 100 staff, I believe, based on my experience, to read each of those in depth, do the analysis, and vote the 8,000 proxies in a global marketplace.

If you had to add those staff to your pension fund or your mutual fund, it would drive up the cost to investors significantly and reduce their returns. I doubt people want to do that.

Fifth, there is a significant amount of transparency today when it comes to proxy voting. ISS, to their credit, goes through a phenomenal public comment process, not dissimilar from what the Federal regulators here in this government do. They post their guidelines to their Web site; they talk about their methodologies on their Web site. Most proxy and pension funds also post their proxy voting guidelines, as I have previously mentioned.

Sixth, pension and mutual funds do not view their proxy voting guidelines as rigid documents. Quite often, when the circumstances are appropriate, we will turn around and vote differently than their guidelines. It is not a one-size-fit-all, as some would argue.

Seventh, if there is a bias in proxy voting it is, in fact, towards management. In 2002 at PERA, we voted with management about 86 percent of the time. Even on shareholder proposals, we still voted with management about 60 percent of the time.

And I think in the statement by the Council of Institutional Investors, and the statement you heard from Florida, they also indicated a bias towards management. In fact, on the say-on-pay proposals so far to date this year, there have been approximately 2,473 votes, and only 31 have failed; less than 2 percent have failed.

When I was going to college, I would have signed up quickly for any class where you had a 98.5 percent passing rate. This is not way out of the mark.

Eighth and finally, I will just say that there are about 100 proxy voting contests each year that get a lot of attention. It is typically because of a lack of performance, if you looked at the recent example on Hewlett Packard, for example—very contested, a lot of visibility in the media. In that case, Hewlett Packard had been underperforming in the market, had lost over $30 billion in market share, had turned around and had negative performance in excess of 20 percent over the previous 5 years, and was in the lower quartile in their industry during that time period. That is what causes the disputes on the proxy voting.

Thank you, and I would be happy to answer any questions.

[The prepared statement of Mr. Turner can be found on page 345 of the appendix.]

Chairman GARRETT. Great. Thank you.

So again, I appreciate the panel's testimony, and we will now go to questioning. I will try to run down the list in 5 minutes.

Chairman Pitt, in your written testimony you didn't exactly say, you inferred, that the Egan-Jones no-action letter is one of the main reasons that the largest proxy firms—we just basically have two of them, a duopoly at this point. So for all practical purposes, is it correct to say that the decision by the SEC—and that was done by the staff, correct, not by the Commission—has eliminated

any fiduciary responsibility for the actual mutual funds themselves and the investment advisors?

Mr. PITT. I think it is correct to say that those letters have enabled institutional investors to sidestep their fiduciary obligations instead of actually fulfilling them themselves.

Chairman GARRETT. Right. And if they had a fiduciary responsibility—just to lay this out clearly—that responsibility would be to whom?

Mr. PITT. That is correct. They have—

Chairman GARRETT. To whom would it be if they had a fiduciary responsibility? Who were you talking about? To the investor?

Mr. PITT. They do have clear fiduciary responsibilities.

Chairman GARRETT. If those letters basically obviated, eliminated, diminished the fiduciary responsibility by the mutual fund or the investment advisor to the little investor out there, let's see, did it shift that responsibility someplace else? Does the proxy advisor now have that fiduciary responsibility to the investor?

Mr. PITT. No. The fiduciary duties still remain with institutional investors. They cannot divest themselves of their fiduciary obligations.

What the no-action letters do is provide a vehicle for them to outsource the exercise of—

Chairman GARRETT. Right. So basically, it says it satisfied the responsibility by going to a proxy advisor.

Mr. PITT. That is correct.

Chairman GARRETT. Right.

Does the proxy advisor—if I am the little investor, does the proxy advisor now have a fiduciary duty to me, because I can't go back to the mutual fund?

Mr. PITT. I believe that they do not have the same fiduciary duties that the institutional investors have because the institutional investors owe their fiduciary duties to the shareholders in those institutions. Proxy advisory firms—

Chairman GARRETT. Right.

Mr. PITT. —do have clear obligations of truthfulness and the like, and those are akin to fiduciary duties, but they are not the same fiduciary duties.

Chairman GARRETT. Someone on the panel—I don't think it was you—made reference to the idea of just making them responsible as an investment advisor. Would that solve the problem?

Mr. BARTL. Yes. I don't think that was me, but—

Chairman GARRETT. No, it wasn't. But would that solve the problem? Because you were the one who said—

Mr. BARTL. In terms of registration as an investment advisor, because of the services that proxy advisors provide, it in and of itself is not going to put them in the shoes of investors because they are in sort of a quasi-role between analyzing company plans and giving advice to investors. It is almost a different animal altogether.

Chairman GARRETT. Right. You did point out, though, that they basically just don't have, as you put it colloquially, a "horse in the race," so they don't have that interest in it.

But you also raised also another potential conflict, which is interesting, with regard to the advice that they actually sell to the firms as well, which puts them into an additional conflict situation.

Mr. BARTL. Yes. And the interesting part here is that the companies still perceive that there is an advantage, and when proxy advisors provide advice on one side of the house and the other side of the house is giving the rating, regardless of whatever disclaimers are made—in fact, ISS even says, "Don't tell us by contract—don't tell us that you talked to our consulting side if you come to the research side to tell us about your proxy"—it is a bit of a kangaroo court. The—

Chairman GARRETT. Let me just break, because I only have 30 seconds here—I appreciate your kangaroo court opinion.

Ms. Stuckey and Mr. McCauley—Ms. Stuckey, you sort of say that the one-size-fits-all does not work for these, and Mr. McCauley sort of indicates that is true in the sense that 67 percent of the firms don't rely upon them exclusively for the advisors. And yet some firms rely on them exclusively. Is that right, Ms. Stuckey?

Ms. STUCKEY. That is right. There is even a recommendation-only service that some investors can buy where they don't even get the reports at all because they don't have time to read them. It is really the lowest common denominator; it is like a compliance obligation on behalf of many smaller investors—not Mr. McCauley.

Chairman GARRETT. Right. Just checking the box. I appreciate that.

And my time has expired.

I now recognize the gentleman from California.

Mr. SHERMAN. Mr. Turner, I want to thank you for pointing out that the same proxy advisory firm could tell two different clients a recommendation to vote in different ways just because they are given different criteria and they correspond to that criteria, just as a beer advisor might advise me to buy one beer because it tastes great and advise him to buy a different beer because it is less filling.

In California, we do everything by referendum. In effect, every voter gets a proxy statement from the California Secretary of State; it is paid for by the corporation, that is, the State government legislature puts various referendum on the ballot. And the opponents get as much space in that book as the proponents of those referendum.

Few Democrats and, I assure you, many fewer Republicans would advocate that only the management of the California legislature be allowed space in that proxy statement. If anybody wants to draw an analogy to the corporate world, they are welcome to do so.

Ms. Stuckey, if someone was listening perhaps not as closely as they should have to your testimony, they would have thought you were advocating that these recommendations all be filed with the SEC where they would be public. That would mean that everybody who wanted to see these reports could see them for free and that would, of course, abolish the proxy advising industry.

I have a series of questions I want to ask everybody—

Ms. STUCKEY. May I respond to that?

Mr. SHERMAN. No, because I am sure you didn't mean to do that. I just want to caution those who might not have listened carefully enough to your testimony. I want to go on.

We are here to talk about shareholder rights.

Mr. Turner, you are representing yourself, but everybody else here is representing an organization, so I would ask them to respond as to official positions of their organization.

Please raise your hand if the folks you represent have taken a position in favor of requiring cumulative voting for all corporations publicly listed.

Only Mr. McCauley's hand goes up.

How many of your organizations have taken a position in favor of information being in the proxy statement about $1 million-plus political expenditures?

No hands go up.

We have a circumstance where you may have a management and a board that is just doing a terrible job, and yet it takes 3 years to vote on the board because only one-third of the board is up every election. How many of your organizations have taken a position in favor of allowing the entire board to be replaced within 365 days?

Mr. McCauley raises his hand; no one else raises their hand.

As I alluded to before—and I know that we would have to—if we wanted a statute on this, we would have to package it a different way to pass the courts, but there are those who think that if 5 percent of the shareholders want to put forward a proposal or an argument to vote for a particularly different slate of directors, that they should be able to use corporate money to do that just as the corporate management does. How many of you favor a proposal along those lines?

Mr. McCauley raises his hand—thank you very much—for the record.

Mr. Pitt, I heard you say that the proxy advisor had an obligation to advise the investors based upon their economic interest. Do I have that right?

Mr. PITT. To further the economic interests of investors, yes.

Mr. SHERMAN. Okay. So let's say I want to invest not for rate of return but I want to invest in companies that will build a strong manufacturing base in the United States even if that gives me a lower rate of return. Should it be illegal for me to find a proxy advisor who will help me achieve that objective through my votes in the companies I already own?

Mr. PITT. Absolutely not.

Mr. SHERMAN. So we should have investment advisors who give advice based on something other than the economic interest of the investor.

Mr. PITT. I think your point is that the advice should be tailored to the interests of investors, and I quite agree with that.

Mr. SHERMAN. Okay. Should a pension plan management be subject to lawsuits alleging that they have breached their fiduciary duty simply because they chose to invest or vote based on what they thought was good environmental policy or good antiterrorism policy?

Mr. PITT. If they are subject, for example, to ERISA, yes.

Mr. SHERMAN. Did your organization support legislation that would allow pension plans to divest from those companies investing in Iran?

Mr. PITT. I am sorry, to invest on what?

Mr. SHERMAN. To divest from those companies investing in Iran. Did you support or oppose that legislation?

Mr. PITT. No.

Mr. SHERMAN. You did not support or oppose?

Mr. PITT. I'm sorry. I know I am—

Mr. SHERMAN. Okay. There was legislation before this committee—finally passed years too late—over the under-the-table opposition of the organization you are representing that would simply allow Mr. McCauley to divest from companies giving money to the ayatollahs in Iran without facing lawsuits, and I wondered if that was still your position.

Mr. PITT. I don't believe that the Chamber opposed that legislation.

Mr. SHERMAN. There was a reason it didn't pass until long after it should have.

I yield back.

Chairman GARRETT. The gentleman yields back.

The gentleman from Virginia?

Mr. HURT. Thank you, Mr. Chairman.

I do have a couple of questions for the panel. I did want to allow Ms. Stuckey the opportunity to respond to what the gentleman from California alleged in his question.

I just wanted to give you a moment to respond, if you would like?

Ms. STUCKEY. I would just like to say that we are not advocating these proxy advisory firms be put out of business. We believe they have every right to exist.

But yes, I did say that we would like their reports filed and they could be filed after the fact. We don't want them to give away their competitive information, but we do think that having the reports filed will make them think harder about what they are doing and making sure they get it right.

Mr. HURT. Thank you.

I guess, let's start with Mr. Pitt on this question: Obviously, the SEC has the responsibility to encourage capital formation, investor protection, and fair and efficient markets, and to that extent, Congress has that responsibility, I think, to encourage policies that do encourage capital formation and encourage that formation to take place in our public markets that have served us well, I think, since the founding of our country. And so to that extent, it seems that this is an important issue that results or has consequences for those three objectives of the SEC.

You said in your statement, I believe, that you don't think these issues necessarily require more government regulation, but I would like to know what specifically we or the SEC should be doing to solve the conflict of interest problem and, perhaps, the misalignment of fiduciary duties? If you could just address that, and then I would like to hear from Mr. Bartl and Mr. Holch.

Mr. PITT. Yes. I think first and foremost what the Chamber has done is published best practices and core principles. It would be very constructive if this subcommittee encouraged all of the participants to engage in a good faith, meaningful dialogue on those principles, and to come up with a consensus view on the ways in which this industry should be performing and should practice, and I think if that occurs, there may never be a need for formal regulation. If

that doesn't work, obviously this subcommittee should consider additional steps. But until that dialogue begins, there is clearly no predicate made for a regulatory solution.

Mr. HURT. Okay.

Mr. Bartl?

Mr. BARTL. Yes. Thank you, Vice Chairman Hurt.

I think one aspect—and I talked about it in my testimony—but is persistent and ongoing oversight in conjunction with maybe the development of best practices because those that are overseen by the SEC and by this body tend to pay more attention, and we saw that in my peer group example.

The other thing is that regulation may have the effect of entrenching the existing participants in the system, and there was actually another player in this space until 2 years ago, Proxy Governance, and one of the things they commented on was the ability of the larger players in this space to basically wipe them out economically. So if we are looking for greater competition, as Mr. Scott talked about, that is one thing to keep in mind here.

Mr. HURT. Thank you.

Mr. HOLCH. Congressman, the Coalition is for regulation here—not something of Dodd-Frank complexity, but what I would call light touch regulation. We do believe that we will need some ability to regulate in order to solve these problems. We are not opposed to best practices as an approach, but we do believe that these—

Mr. HURT. What are the specifics of—

Mr. HOLCH. Sure. ISS, for example, is already registered as an investment advisor, but the Investment Advisors Act—the current framework really doesn't apply to their role. Their role is very unique. They are not selecting investments for their clients; they are providing advice on proxy voting.

And so we think the SEC should create a unique regulatory framework that reflects their role using their authority under the Investment Advisors Act: first, we would be for registration; second, we also think that unique framework should address some of these transparency problems that we have identified, address the factual inaccuracy issue that we have also talked about; and third, we do think both the SEC and the Department of Labor should evaluate their fiduciary duty rules and interpretations regarding investment advisors just to clarify and to make sure that these investment advisors are providing the proper oversight.

Mr. HURT. Thank you.

Chairman GARRETT. I thank the gentleman.

The gentlelady is recognized for 5 minutes.

Ms. MOORE. Thank you so much, Mr. Chairman. Before I start my questioning, I would like to ask unanimous consent to enter into the record the testimony of Sean Egan, chief executive officer of the Egan-Jones Rating Company. It has been mentioned here.

Chairman GARRETT. Yes. Without objection, it is so ordered. And since you are doing that, I will use this time also to enter into the record a—

Ms. MOORE. You are using my time—

Chairman GARRETT. No, I won't be using your—oh, your time is—

Ms. MOORE. Right.

Chairman GARRETT. [Off mike.]

Ms. MOORE. Right, right. So get that clock back—my 25 seconds.

Chairman GARRETT. I wasn't going to use your time. I agree to just entering testimony into the record.

Ms. MOORE. Okay. You are running the hearing. You can do it, but—

Chairman GARRETT. We are going to reset you to 5 minutes; and we are going to put the June 4th letter from the Mutual Fund Directors Forum into the record, as well. Without objection, it is so ordered. And the gentlelady's time is set back to the original 5 minutes. I will even throw another 10 seconds on—

Ms. MOORE. Thank you so much, Mr. Chairman.

I just want to start out by thanking the panel for coming. This is a very, very interesting conversation.

I think that I heard some really broad agreement here, some things that we need to think about whether or not the SEC ought to regulate this industry more adequately. I think we did hear some agreement—perhaps not from Ms. Stuckey; I am going to ask her some more questions—about the value of having these rating companies do the intense research that they have done.

And so with that, let me start out by asking Mr. Pitt—Honorable Mr. Pitt, I found it very interesting in your testimony that you said these rating companies didn't have a horse in the race, or skin in the game, so to speak, and so I was wondering whether or not you thought that—and since another objection that many people have is that there are often conflicts of interest, I was wondering if you didn't think that by them not having a horse in the race, their information might be more objective and it might be as a service?

Mr. PITT. I don't believe that affects their objectivity. Glass Lewis, for example, has a parent that is an activist investor and Glass Lewis takes positions on their positions. ISS takes positions with respect to companies that also purchase corporate governance services from them, so—

Ms. MOORE. Okay. Okay, thank you. That is good information. Do you think regulation would change that?

Mr. PITT. I think best practices and adopting fiduciary standards would help.

Ms. MOORE. Okay. Thank you for that.

Ms. Stuckey, I was very interested in your—everybody else seemed to think that these companies did bring something to the table, and maybe you clarified it a little bit when you were given time to say that you don't think they should be out of business, but you say that they produce a product and the—sort of the cost-benefit is not realized. I guess I wanted to hear just a little bit—a few seconds—about whether or not you thought they brought any useful information to the table.

Often, companies internally cannot afford to do all this research that they need in order to make good investment advice, so I wanted you to clarify that for us.

Ms. STUCKEY. We are companies. We like our shareholders. Our shareholders tell us they need this type of information from the marketplace. We don't have a problem with that.

Ms. MOORE. Okay, good. I—

Ms. STUCKEY. We don't have a problem with that. What we have a problem with, though, is when we write a 100-page proxy according to the SEC rules and then the services take the proxy and they use junior people, perhaps—they use people who they—they are trying to make money so they use maybe people who don't really understand these things—they are complicated, they come up with a summary report which then gets sent to the investors—not all investors, but a lot of them—and they don't have time to read our proxy—

Ms. MOORE. I understand.

Mr. Turner, I am going to let you have the last word on this. You mentioned something that hasn't come up previously in questioning about the board of directors' lack of access to the ballot, and how it disadvantages certain types of proxy voters like labor unions. So I want you to talk about that, and also I want you to respond to the whole skin in the game and cost-benefit points that have been made.

Mr. TURNER. I do think having access to the proxy is extremely important for investors. At our pension fund, which represents half a million investors, the fund has voted to support proxy access, so we are a strong proponent of that, as many of the funds are.

As far as the cost-benefit here, first of all, it is not just junior staff who are preparing these things. That is a misnomer; that is a myth that needs to be busted wide apart. Those things are reviewed by senior people on up.

It is just the same as an audit firm does when they do an audit. Junior staff do a lot of the work. Congressman Sherman knows this very well. But before that product goes out, senior people up the level do review it, so they are credible.

And in fact, I have found in using their reports that most of the time, they are credible. If you are going to do 40,000 reports a year, are there going to be some misses? Yes. But for the most part, they are well done.

And the benefit of that to the investing public is immense because you usually get—in our case, we even get not only one research report, we get a couple of pieces of information that supplements what we do as our people do read the proxies at the PERA board, and it does provide a number of different viewpoints, which is the best way to become a well-informed voter. So I think the system does work.

I actually do agree, I would do some form of registration and take care of the conflicts, but for the most part, the system is much better than what some would say.

Ms. MOORE. Thank you.

Chairman GARRETT. I thank the gentlelady, and I thank the gentleman.

The gentlelady, Mrs. Wagner, is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman.

And I would like to thank the witnesses for being here today.

Mr. Morgan, I want to focus specifically on retail investors and how the proxy process is working or not working for them specifically. In your opinion, do you feel that the proxy process is easy for the average retail investor to understand?

Mr. MORGAN. Thank you for the question, because they are the missing piece in all of this.

Mrs. WAGNER. I agree.

Mr. MORGAN. Retail investors do not have access to the—because they don't pay the fees to proxy advisors. Most of them are not registered with the company; they are in street name.

So they come through a proxy process and there is not a lot of communication. They get their proxy. As Darla said, it is 100 pages. They look at it, they are confused. Many of them don't vote.

Retail voter accounts that vote is about 14 percent. It is terrible. We just don't have the retail shareholders engaged, and I—part of the changes to a proxy system would hopefully address that to allow them to become reengaged in the process—

Mrs. WAGNER. Let me get to that. So you do believe that it is the complexity, I guess, of the proxy process that has led to a lower level of retail investors' participation?

Mr. MORGAN. I would say it is the complexity as well as we are legally required to provide these proxies, and in order to meet all the requirements; they are very dense. So it makes it very difficult for a retail shareholder who isn't engaged in this to understand them.

Mrs. WAGNER. Then what steps can we take to simplify the proxy statements so that the information could actually be meaningful to retail investors?

Mr. MORGAN. I think part of it is when we tell investors something, let's tell them once, and put all this information out there so it is easily understandable. I think looking at the system, as we have talked about, registered shareholders versus those in street name, we need to look at the process and try to bring it back to how it was to where there is more dialogue and engagement so they feel more informed when they are making their decisions and feel more empowered.

Mrs. WAGNER. So then the complexity, would you say, of the proxy system has caused almost an overreliance on proxy advisory firms at the expense of retail investors?

Mr. MORGAN. I wouldn't necessarily say that. I would say that retail shareholders are on their own, and by being on their own they don't have the tools that institutional investors do.

Mrs. WAGNER. All right. Let me focus with Chairman Pitt, please, if I could.

There are thousands of public companies that had nothing to do with the financial crisis of 2008, yet a number of these companies have been targeted by activist shareholders in recent years. Dodd-Frank was passed as a supposed antidote to the financial crisis, but how has Dodd-Frank encouraged some of these activist shareholders to promote their agendas at nonfinancial companies?

Mr. PITT. It has in many ways. For example, it undertook to Federalize a large portion of corporate governance, which heretofore has been the province of State law. That in itself has been a very troubling development as part of the legislation.

It then takes issues that are perhaps important but that don't affect the material outcome of a company's behavior, such as conflict minerals—

Mrs. WAGNER. Right.

Mr. PITT. —doing business in certain countries, and it has now encouraged people to use corporate disclosure documents for purposes other than informing investors.

Mrs. WAGNER. I think you are quite right.

I want to also ask about what was in your testimony regarding Section 951 of Dodd-Frank, the so-called say-on-pay provision. Why do you feel that ISS and Glass Lewis decided that these say-on-pay votes should be held yearly as opposed to every 2 years or even every 3 years?

Mr. PITT. The problem with this is Congress, in its wisdom—and it was wisdom—gave companies and shareholders a choice of 1, 2, or 3 years. But ISS and Glass Lewis adopted a one-size-fits-all position and have effectively been able to mandate that all corporations do this on a yearly basis. This is expensive and it doesn't produce any value for shareholders, and there are studies that say it actually has acted to the detriment of shareholders.

Mrs. WAGNER. All right. Thank you.

Mr. Chairman, I think I will yield back my time since it is waning. Thank you very much.

Chairman GARRETT. If she yields it to me, I will just ask this question to Mr. Morgan: Glass Lewis is owned by the Ontario Teachers Fund, correct?

Mr. MORGAN. Correct.

Chairman GARRETT. So where are the retail investors who are looking to being protected in that situation? Who is Glass Lewis actually responsible to, their owner or the retail investors?

Mr. MORGAN. They are, as an institutional investor those institutional investors represent those individuals, so there is an intermediary there. So we were talking two different things. One is the direct—

Chairman GARRETT. Understood. But is there a potential for conflict when you have a proxy advisor being owned by a—

Mr. MORGAN. Oh, absolutely. It is a huge potential conflict.

Chairman GARRETT. Thank you.

With that, I yield to Mr. Scott for 5 minutes.

Mr. SCOTT. Thank you, Mr. Chairman.

Like to continue a line of questioning from my colleague who mentioned about the say on pay. It is good for us sometimes to be able to look around corners to see what is coming, and there is a gathering storm that is coming at us, and it is this huge gap in pay. We dance around it.

But I want to ask you, because—and I mentioned the question about just having 2 firms control 97 percent of the market, and let me just give you a glaring point on why this compensation issue and perhaps this almost monopoly with two companies might have something.

Last year, proxy advisor firm Glass Lewis urged votes against management on their pay and compensation 17 percent of the time. ISS urged votes against their management on their compensation pay 14 percent of the time. But yet, 98 percent of U.S. companies got the majority of support on their compensation plans last year.

And I am wondering, at what point are we going to begin to realize that this cannot continue?

We are a mass consumption economy, which means our success hinges on many, many people being able to buy many, many things. And so, the credibility is at stake. It is these people who invest in the market—in their pensions, in their retirements.

I am wondering, and I would like to ask—perhaps Mr. McCauley or Mr. Pitt or Mr. Turner may have touched upon some of this—either of you, what must we do about this? Why is it that, one, we have just 2 companies controlling 97 percent of this, and does this have anything to do with why we are not getting the kind of response to taking a very jaundiced eye look at the seriousness of this huge gap on compensation between the top and the middle and the bottom and the impending damage that it could do to our economy?

Mr. PITT. The reason I think we only have two companies is because of the government policies that have existed, and I would urge you to consider an analogy. We saw the exact same thing with credit rating agencies before the 2007 and 2008 meltdown, where competition based on government policies was reduced and restricted. And as one of the panelists indicated, new entrants into this field have found it impossible and have been unable to compete. So one problem is that there is no facilitation of competition here.

The issue you raise about compensation, in my view, is a very serious one. I start from the premise that people should be rewarded for performance, not for having a pulse. And so when compensation comes up, it is absolutely crucial for companies to do the due diligence that is required to set what standards they want and then to develop metrics to measure whether senior executives have actually met those metrics.

Although the SEC has tried to promote better disclosure, the real problem is that many companies today simply cannot get their arms around the process of setting compensation.

The one place where I have a concern, however, is that I don't think it is the appropriate role for government to try and figure out what is good compensation or appropriate compensation. But I do agree with you: The bigger the disparity, the more potential problems we will have, and it is up to companies to do the discipline and then make appropriate disclosures of what they have done.

Mr. SCOTT. I thank you.

Chairman GARRETT. Mr. Hultgren is recognized for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman.

Thank you all for being here.

Chairman Pitt, wonder if I could address some questions to you. Can you describe how the SEC's regulation of proxy voting—specifically the 2003 rules governing institutional investors' fiduciary obligation to clients when voting client proxies and also the 2004 no-action letters—contributed to the rising influence of proxy advisory firms over the last decade? And also, how is this scenario similar to the SEC's rule mandating the use of credit rating agencies?

Mr. PITT. Yes. In 2003—and I was Chairman at the time—the Commission adopted rules which said that registered investment advisors should disclose how they—what policies they apply in voting proxies, and then at some point after a vote was taken disclose how they voted so people could see whether the policies aligned.

And the theory was, these shares belong to the investors not to the managers, and therefore there at least ought to be policies with respect to that.

What happened thereafter was that the SEC staff issued two no-action letters, which effectively permitted registered investment advisors to obviate their own responsibilities with respect to voting and instead rely on proxy advisory firms as a general proposition to eliminate potential conflicts that any investment manager might have with a particular company situation.

The no-action letters were unique in that instead of responding the way most no-action letters do, as you would write in, for example, to the SEC and say, "Here is what I am planning to do. Can I do this?" And the SEC would say, "Yes, you can do it, based on the facts we know. We won't bring any action." These no-action letters effectively amended the SEC's rules without any action by the Commissioners.

What this did was create an impetus in favor of the two largest firms and the existing firms and made it easier for them to sell their services based on the fact that there was no requirement for investment managers to look to their own conflicts of interest if their policy was to solicit and get advice from these third party persons.

With respect to credit rating agencies, the SEC had provisions—and I was astounded to learn this when I got back there—that established nationally recognized credit rating agencies and then made it impossible for other entrants to compete. And the result was that you had an oligopoly and a lack of real standards.

Mr. HULTGREN. You kind of touched on this, but Chairman Pitt, by allowing mutual funds and investment advisors to outsource that fiduciary duty to act in their client's best interest when voting their proxies to proxy advisory firms has the SEC effectively decoupled the voting decision from the fiduciary duty?

Mr. PITT. I am sorry. Has the SEC—

Mr. HULTGREN. Effectively decoupled the voting decision from the fiduciary duty?

Mr. PITT. I think that is a fair statement.

Mr. HULTGREN. Taking this a little further, should mutual funds and investment advisors be allowed to outsource that fiduciary duty to proxy advisory firms in your opinion or in the thoughts of the Chamber? And what reforms—I know you have talked about some of these in your statement, but what reforms need to be made to ensure that proxy advisory firms are making recommendations that enhance shareholder value?

Mr. PITT. Let me say first that the Chamber is studying this issue. I can answer for myself, and my view is that outsourcing of fiduciary responsibilities breaches the whole concept of fiduciary duty, so I believe that the answer has to be yes, you can go out and obtain this kind of guidance, but in the end you must exercise your own fiduciary responsibilities and you cannot rely on others to do that for you.

Mr. HULTGREN. Okay.

Mr. Chairman, I see my time is just about out. I will yield back. I don't know if you have a—

Chairman GARRETT. No. I will—

Mr. HULTGREN. Okay. I yield back. Thank you.

Chairman GARRETT. Thanks.

I now recognize Mr. Mulvaney.

Mr. MULVANEY. Thank you, Mr. Chairman.

It strikes me that many of the complaints we are hearing are sort of typical when you are operating in a marketplace where there are only two providers, or 2 providers provide 97 percent of the services, so I want to drill down a little bit on the questions that my colleagues, Mr. Scott and Mr. Hultgren, just asked and start with you, Mr. Pitt, because clearly one reaction would be to regulate this industry because of the apparent concentration of market power, but obviously competition would be another possible solution.

You said a couple of times in the last couple of answers that there are government policies that are preventing new entrants, but I haven't heard the specifics yet on what those policies are. What is it specifically that the government is doing that is preventing you and me from going into this business and starting a new competitor?

Mr. PITT. I think that some of the policies that exist are an indifference, if you will, to the fact that the existing advisory firms engage in a one-size-fits-all approach, that there is no sense of concern about the failure of the two major proxy advisory firms to consider the best financial interests of shareholders, and—

Mr. MULVANEY. Okay, but let me catch up. Indifference is not a policy. There is a difference between the government getting involved to promote competition, okay—we could do things to try and encourage competition, but there are also things we do to discourage competition.

Is there anything that this government is doing now that is discouraging me and Mr. Hultgren from getting into this industry? Because indifference is not a policy.

Mr. PITT. Yes. I think with respect to the subject of the no-action letters, for example, the grant by the SEC staff of the ability of the existing proxy advisory firms to permit registered investment advisors to focus on their general policies instead of whether there is a specific conflict has diminished the ability to create competition in this field.

Mr. MULVANEY. So if you and I, or me and Mr. Hultgren, want to start another—we can't get that same treatment. Is that what you are saying?

Mr. PITT. Yes.

Mr. MULVANEY. Someone else help me out here. What am I missing? Is there something else? Why aren't there more competitors in this market?

Don't everybody jump up at one time.

Mr. HOLCH. I will take a crack at—

Mr. MULVANEY. Mr. Holch, yes, sir?

Mr. HOLCH. I think one of the problems is for institutional investors you need to have a certain amount of scale to function in this market. You have to cover 13,000 annual meetings. The proxy statements, as Darla Stuckey said earlier, average 100 pages. You need to be of a certain size to really service the marketplace.

There have been other firms that have tried to get into the retail space and have really failed miserably because the retail shareholders won't pay for it, either. So I think there is a sort of a price and a cost dynamic that makes it really difficult to compete.

Mr. TURNER. Having started Glass Lewis, I would totally agree with that. There have been others in the marketplace that didn't get to the scale and failed financially, so you have to be able to almost immediately—we had to go out and get venture capital backing to give us the ability to ramp up quickly because we had to be able to cover 5,000 or 10,000 companies right out of the gate, so you have to have the ability to raise some money, to ramp the scale, put in the technologies, and then get institutional investors to be willing to sign on.

And they are reluctant to sign on to someone who has never done it before, so—and it is not a big marketplace. If you look at the revenues at Glass Lewis and ISS combined, they are probably in the $250 million to $350 million range. This is not a big marketplace. The ability to get a return if you do invest in a company like this is not that great, so I just don't think you are going to see—financially the market just isn't going to support any other entrants.

Mr. MULVANEY. Mr. Bartl?

Mr. BARTL. Yes. It is interesting. If you look at the current market participants and the scale and the competition between them, you have one player in ISS that is substantially bigger. When Glass Lewis makes an attempt to move, you see a countermove as well by ISS, and if you look at the announcement by Glass Lewis last spring of greater engagement with its investors, ISS announced its feedback review board. Whether the two are connected, I don't know, but you saw that.

Mr. MULVANEY. Okay.

Mr. BARTL. You saw peer groups with Glass Lewis and using a more market-based participation. In addition to the blow-up I discussed on peer groups, ISS adopted a similar procedure as part of its procedure when it revised its process for 2013. So, getting into the market and staying in deals with market participation, and this has been discussed in other settings before by other organizations that have explored the competition in the market.

Mr. MULVANEY. Okay. That is helpful, because that is not where I thought Mr. Pitt was going. I thought there was something we were doing to prevent that type of competition, which you have just described can be experienced in many industries where economies of scale simply prevent new entrants, so that is sort of a natural barrier to entry.

And there are different ways to deal with that, Mr. Pitt, than dealing with something we are doing to affirmatively prevent competition, so that is extraordinarily helpful.

I yield back. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you.

The gentleman from California?

Mr. ROYCE. Thank you, Mr. Chairman.

I would like to ask Mr. Pitt a couple of questions. Last year, Glass Lewis offered vote recommendations for the Canadian Pacific Railway shareholders meeting and the Ontario Teachers Pension Board, the parent company of Glass Lewis—opposed the board of

directors of the Canadian Pacific Railway. Not surprisingly, Glass Lewis issued a recommendation that shareholders oppose the incumbent board of directors and vote for an alternative slate.

According to a letter sent by the Chamber of Commerce to the SEC, the case represents tangible conflicts of interest in the operation of proxy advisory firms.

What I wanted to find out—the chairman has discussed this issue, and you have alluded to it as well—is how common are these types of instances, and would disclosing a conflict of interest such as this be sufficient or, in your judgment, Harvey, is it necessary to take more prescriptive measures in order to address this, other than just disclosure?

Mr. PITT. I think that at present, the disclosure that exists is very vague and generic, i.e., "We may have positions or our parent may have positions," and then Glass—

Mr. ROYCE. That is not disclosure, right—

Mr. PITT. It is not. When I was chairman, that is what the research analysts did, and we prohibited that.

Mr. ROYCE. Right.

Mr. PITT. I think one thing that has to occur is you have to disclose real conflicts on real time. The second is there has to be an accepted standard of behavior for these firms.

We think that can be achieved consentually. If that fails, then there may be a need for government action, but right now ISS and Glass Lewis have no interest in developing appropriate standards on conflicts.

Mr. ROYCE. The post-Andersen debacle led to a situation where what was once presumed effective Chinese firewalls—clearly post-debacle that was addressed, and we get into the issue here of ISS, and certainly the SEC and the GAO both pointed out conflicts of interest arise when an advisory firm runs a consulting business alongside its proxy advisory services.

And there are times when they may be asked to advise on shareholder proposals sponsored by someone who obviously is also paying them on consulting work. Now, what is surprising is when you go through the record how many cases you can find.

In 2011, AFSCME sponsored a shareholder proposal at Target Corporation, and that same year AFSCME paid ISS as a client. In 2010, the Nathan Cummings Foundation sponsored a shareholder proposal at Masco while paying ISS for, again, advice. In 2010, the Connecticut Retirement Plans and Trust Funds sponsored a shareholder proposal at Abercrombie and Fitch, and that same year the Connecticut State Treasurer confirmed in a letter to the SEC that the State was a client of ISS, and that she would support initiatives to clarify potential conflicts of interest on the part of proxy advisory firms.

So sure, these should be disclosed, but I want to take it a step further. And maybe I could ask Mr. Morgan on this, because Mr. Morgan in his written testimony called this an inherent conflict of interest.

The question is, what would the solution be, in your opinion?

Mr. MORGAN. Certainly, if you can't regulate it starts with transparency, and those conflicts should be stated and shown on any recommendation that they make that they are also providing con-

sulting services for these activists or whoever is proposing that position. So I think that would be the starting point so that when the recommendation is read you can see that there is—they have also supplied consulting services.

Mr. ROYCE. Harvey, would that be sufficient, in your opinion?

Mr. PITT. It could be. I think one of the things that would solve this problem would be to eliminate the effect of these no-action letters that permit firms not to detail specific conflicts of interest before they recommend positions with respect to those companies.

Mr. ROYCE. Thank you. Thank you, Mr. Chairman. I yield back.

Chairman GARRETT. The gentleman from California now yields back.

That concludes the questioning from all the Members who are here. We have just agreed with the ranking member that we will—if the panelists can sit through 10 more minutes, we will do an additional 5 minutes on each side.

The gentleman from California will have his 5 minutes. I will share with whoever is still here on our side, or I will use the 5 minutes.

But with that, I will yield to the gentleman from California.

Mr. SHERMAN. I will, of course, generously share my 5 minutes with all the other Democrats who are here.

Mr. Pitt, do I as a—let's say there are two panels running for board of directors, one of which is committed to divesting from Iran, protecting the environment, and promoting American jobs. The other, in my opinion, is going to earn one cent more per share for all the shareholders. Do I as a shareholder have a fiduciary duty to my fellow shareholders to vote for that second panel?

Mr. PITT. I don't think fiduciary duty determines which way you vote. I think fiduciary duty dictates that your standard should be what is in the best interests of those to whom you owe the duty, and—

Mr. SHERMAN. As I said, these are my own shares.

Mr. PITT. If you conclude that in the long run, a certain vote will promote the best interests of those shareholders, then—

Mr. SHERMAN. Okay. I own these shares. They are mine. Do I have a fiduciary duty to vote in the best interests of all those other people who have invested in IBM stock?

Mr. PITT. No.

Mr. SHERMAN. Or can I—okay.

Mr. PITT. No. You vote your shares for any reason.

Mr. SHERMAN. Ms. Stuckey, you suggested an after-action filing of the report. Let's say the Smith Family Trust has decided—its trustees—a big foundation, maybe a big family trust—that they want to divest from Iran but they have decided they don't want to divest from Sudan. If the report given to them by their investment—their proxy advisors is filed with the SEC then everyone in the country will know that the Smith family is good on Iran but they are not tough on Khartoum. Is that fair?

Ms. STUCKEY. I think so, under that scenario.

Mr. SHERMAN. So you think that if the Smith family—just a family trust, a couple of brothers put their money in—have decided that they are going to pick their—

Ms. STUCKEY. You don't know for sure that they followed the recommendation.

Mr. SHERMAN. Are you saying that if Jack Smith and John Smith have an investment partnership and they choose to get advice on how to vote their proxies—

Ms. STUCKEY. And assuming they were—

Mr. SHERMAN. —that the entire world has to know what their proxy voting criteria are?

Ms. STUCKEY. If they are an institutional investor with a fiduciary duty—

Mr. SHERMAN. I didn't say an institutional investor; I said Jack and John Smith.

Ms. STUCKEY. Jack and John Smith probably didn't buy the proxy advisory firm services. They are probably a retail—

Mr. SHERMAN. In my example, I said they were relatively wealthy brothers with a big trust. They can buy what they want.

Ms. STUCKEY. Then they have no obligation to—

Mr. SHERMAN. They have no obligation—

Ms. STUCKEY. —follow the recommendations or not. They can just—

Mr. SHERMAN. So now, let's say it is an ERISA pension plan. Do you think they have an obligation to disclose their voting criteria?

Ms. STUCKEY. Yes.

Mr. SHERMAN. Okay.

Let's see. I didn't know we would get a second bite at this apple.

So, Mr. Pitt, is it the Chamber's belief that we should have this race to the bottom by the different States in trying to deprive shareholders of any meaningful control and that corporations should be—publicly traded corporations should be free to incorporate in whichever State has the least cumulative voting, the longest terms for board members, et cetera? Should we have minimum national standards or should we invite States to try to get this business from other States by offering the most pro-management corporate law?

Mr. PITT. With all due respect, there is a mixed metaphor. The Chamber supports high standards; they do not support a race to the bottom. With respect to the issue—

Mr. SHERMAN. How would we get those high standards? Or can you be in a position to say, "We as a Chamber support high standards but we support a system in which States will naturally race to the bottom and the Federal Government won't stop them?"

Mr. PITT. The support should be—and I think is—for the system as originally adopted by Congress, which is that the States decide the substantive rights of shareholders, and there are a lot of very strong reasons why that was a very wise policy.

Mr. SHERMAN. And it has given us the weakest possible shareholder protection.

I see my time has expired. I yield back.

Chairman GARRETT. Thank you.

And for the final 5 minutes, so in the testimony that we have received today on one of the issues dealing with say on pay—and I will throw this out to Ms. Stuckey and Mr. Bartl—Congress was pretty explicit as to how say on pay was going to play out, or should play out, but the way the proxy advisors basically played it

out was in contradistinction to where Congress is. That is to say, it would be, what, every year.

Do you see by them doing that as a conflict or a contradiction from Congress as it is laid out, or as a potential conflict from their interest to the investors in this situation?

I will start with Ms. Stuckey.

Ms. STUCKEY. I think say-on-pay votes being every year certainly increases the need for their services, so they are perpetuating themselves in business. I will add to that, when companies get recommendations that they don't like, they talk to their investors. So they go out and talk to their investors now more than they ever did before.

There are companies that tell us, "We talked to every single one of our top 50 investors, and they all want 3-year say on pay."

Chairman GARRETT. Okay.

Mr. BARTL. I would simply echo that, Mr. Chairman. And even for those who aren't saying, for 3 years now, they have been saying, "We are going to look at this over the time being," simply because the workload involved in an annual say-on-pay analysis versus the benefit received is something that is starting to weigh on the investor, as well. So there is definitely a vested interest in keeping it at one year.

Chairman GARRETT. Okay.

Just two other points. First of all, we got into a little bit—actually, the testimony was Mr. Holch, with regard—and some others, as well—to the point of what can be done, and you laid out some of these points as to help facilitate more direct communications between the entities—the companies and the investors. And I think there is unanimity on the panel that this is something that would be good to work on, and the Congress should take an additional look at, that there is a problem in this area, and this is an area where Congress has a role to try to help facilitate. Mr. Holch?

Mr. HOLCH. The SEC has the authority to repeal their NOBO–OBO rules, which I described in my testimony. The SEC also has the authority to switch the responsibility of communicating with shareholders from the brokers and the banks over to the public companies.

But certainly Congress has a role, and I think it would be great if members of this subcommittee could help us encourage the SEC to move this along. The public company community has waited a long time to try to address these issues and we are supported by a number of institutional investors. There really is a consensus for change, and so we just need to get this up the priority list over at the SEC.

Chairman GARRETT. There are a couple of different areas that we heard from on this overall panel, and hopefully, this is one area where we may find some degree of agreement, and some degree of bipartisanship on as we look at it further.

The area where we may have a little bit more dissention is the role and the—how we deal with proxy advisors. My takeaway—and someone can correct me if it is wrong—is that there is—whether we are talking about the retail—yes, when we are talking about the retail investor, there is still a lack of clarity as to what the obligation is of the proxy advisor to my mom, the small retail investor,

of the proxy advisor. There is no obligation, basically. Yes, not clarity—I should say there is no obligation.

Conversely, there—thank you. Mr. Morgan is agreeing with me that there is no obligation of the proxy advisor to the retail investor.

The other takeaway that I am getting from this as well is that there might be—or there are various conflicts that the proxy advisor currently has, whether it is the one that Ms. Stuckey talked about just now, the one that Mr. Bartl talked about earlier with regard to the selling of services on the side, if you will, and also the one that others have pointed out, the potential conflict of basically who owns these proxy advisors, and who their largest clients also are may influence their decisions as to their advice on these things.

Mr. Turner is shaking his head "no," but as of right now, I can't see why there is not a potential for a conflict of interest when they do not owe me or the small retail investor and there is not disclosure or transparency as to what those potential conflicts are. Those potential conflicts potentially can exist, and I think that is something that we can take a look at.

And I will close on this, on the happy note that I think Chairman Pitt raised, that maybe some of this can be done just on a consensus basis with trying to bring the interested parties together, because now Congress is taking a focus on it. I will end on that happy note, although I think that when two entities have 97 percent of the market share, I have a feeling that they probably don't have a whole lot of interest in trying to reach any compromise on this, but we will remain optimistic.

I thank all of you for your testimony.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, we are now adjourned.

[Whereupon, at 12:00 p.m., the hearing was adjourned.]

A P P E N D I X

June 5, 2013

A Case for Greater Oversight of the Proxy Advisory Firm Industry

Hearing on Examining the Market Power and Impact of Proxy Advisory Firms
Subcommittee on Capital Markets and Government Sponsored Enterprises

House Committee on Financial Services

June 5, 2013

Written Testimony of
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Chairman Garrett, Vice Chairman Hurt, Ranking Member Maloney and Members of the House Financial Services Committee:

My name is Tim Bartl, and on behalf of the Center On Executive Compensation, I am pleased to provide our views on the role, influence and impact of proxy advisory firms. These issues have been a top concern of the Center's for several years, and led to the Center's publication in January 2011 of a white paper, "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight." We used the paper to begin a dialog on these issues both with the proxy advisory firms and more importantly, several leading institutional investors. My comments today reinforce many of the findings and recommendations in the paper and are punctuated by recent examples of why proxy advisory firm accountability and oversight deserve this Subcommittee's attention as well as the SEC's. I would ask that the complete paper be inserted into the record as part of this hearing.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 340 large companies, and the Center's more than 100 subscribing companies are HR Policy members that represent a broad cross-section of industries. Because chief human resource officers support the compensation committee chair with respect to executive compensation and related governance matters, and many are involved in engaging with institutional investors, we believe that our Subscribers' views can be particularly helpful in understanding proxy advisory firm influence and the positive impact regulatory oversight had in 2012.

I. The Role of Proxy Advisory Firms

Proxy advisory firms fill an important role for institutional investors. As the share of institutional investor ownership has grown from roughly 46 percent in 1987 to over 75 percent today,[1] the volume of proxy votes which investors are responsible for casting has grown into the billions. In order to assist them in fulfilling their fiduciary duty to vote their proxies in the best interests of their clients, most institutional investors retain the services of Institutional Shareholder Services ("ISS"), the largest proxy advisory firm, or Glass Lewis & Co., the other major proxy advisory firm. Together, these firms cover about 97 percent of the U.S. market for proxy advisory firm services.[2]

Both ISS and Glass Lewis provide proxy voting research and analysis and make voting recommendations to their clients. Both companies provide an electronic proxy voting platform in which investors can instruct advisors on how they want their votes cast and the proxy advisory firms will execute the votes on investors' behalf. Both allow investors to customize their standardized proxy voting guidelines. ISS will also determine votes for its clients, and, based on ISS comments and anecdotal experience from our Subscribers, many medium and smaller investors delegate their proxy voting

[1] THE CONFERENCE BOARD, 2008 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN INSTITUTIONAL INVESTOR ASSETS AND EQUITY OWNERSHIP OF U.S. CORPORATIONS (Sept. 2008).
[2] James K. Glassman and J.W.Verret, How to Fix Our Broken Advisory System, Mercatus Center (2013), http://mercatus.org/publication/how-fix-our-broken-proxy-advisory-system

duties directly to ISS, following the ISS standard proxy voting guidelines. Glass Lewis does not determine votes on behalf of its clients, but is also less forthcoming about its voting policies and their application.

As discussed in detail below, while most investors take their proxy voting responsibilities seriously, the delegation of proxy voting analysis to ISS and Glass Lewis inserts a significant opportunity for influence over the proxy voting system. Many institutional investors do not view proxy voting as enhancing returns for their clients. This leads to cost pressures on the proxy advisors and impacts the quality of their analyses. This led one commentator, Charles Nathan, then of Latham and Watkins, to observe:

> The effectiveness of this model rests on the assumption that voting decisions can be delegated to specialists and third-party proxy advisors so as to fulfill the institution's fiduciary duties without imposing undue costs on the institution. It is not clear, however, that the parallel voting universe that has evolved over the past 25 years successfully discharges institutional investors' fiduciary duties of due care and loyalty.[3]

The lack of sufficient resources on the part of the proxy advisors leads to a check-the-box mentality, driven in part by the desire of investors to have a uniform, condensed version of corporate pay disclosures, even though pay programs are individualized, complex and lengthy. The speed with which proxy advisors must analyze 100-page proxies, combined with the aforementioned lack of resources, leads to errors, inaccuracies or questionable characterizations. The system belies the reality that pay programs are nuanced and strive to link directly with corporate strategy. To understand and summarize them well requires time, resources and diligence. The irony is that issuers are responsible for ensuring the accuracy of proxy advisory firm reports, even though proxy advisory firms are supposed to be the experts providing information that investors rely on to execute a fiduciary duty. This calls into question the legitimacy of the model, or at least its effectiveness, given that only large companies have the opportunity to review a draft report, and then only from ISS.

Policy Setting: Is It Truly a Reflection of Investor Clients' Views?

Of the two major proxy advisory firms, ISS has by far the clearest and most transparent policy development process. However, the process ISS follows to develop and refine the policies by which it analyzes thousands of company proxies involves a survey which is often relied on in making changes that typically does not have robust investor involvement. Last year's survey, conducted from July 24 to August 31, and incorporated feedback from only 97 institutional investors and 273 corporate issuers.[4]

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[3] Charles M. Nathan, *The Future of Institutional Share Voting: Three Paradigms*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, July 23, 2010, http://blogs.law.harvard.edu/corpgov/2010/07/23/the-future-of-institutional-share-voting-three-paradigms/ (last visited June 3, 2013)

[4] Institutional Shareholder Services, 2012-2013 Policy Survey Summary of Results (Sept. 2012), at 2, http://www.issgovernance.com/files/private/ISSPolicySurveyResults2012.pdf

ISS notes that in addition to the survey, its Policy Board incorporates input from "roundtables with industry groups and ongoing feedback during proxy season" as well as informal discussions.[5] This was clearly the case in 2012, which is an encouraging sign. However, in discussions with institutional investors over the past year, certain ones have raised concerns about aspects of ISS's analyses which have not been changed. This demonstrates that there is still room for further consultation with all interested parties. A major example of a disconnect and its subsequent resolution–the selection of peer groups for the purpose of comparing pay and performance in 2012– appears to have been one turning point in the process and is discussed later in these comments.

Although analyses by proxy advisory firms has improved in recent years, the overall concerns remain with the policies through which proxy advisory firms exert significant influence over proxy voting and executive compensation and governance best practices. The SEC's Concept release on the proxy advisory system took a positive step to review concerns with proxy advisory firm practices, but with other rulemaking priorities likely to take priority, further legislative and regulatory oversight is in order.

II. Proxy Advisory Firm Influence

Both academic research and experience demonstrate that proxy advisory firms have significant influence over the proxy votes cast by institutional investors and over the compensation practices adopted by companies. This is a concern because unlike directors or institutional investors, proxy advisory firms have no economic interest in the company for which they are making recommendations. This removes the consequences of an inaccurate or incorrect recommendation from the recommendation itself.

Influence of Proxy Advisory Firms Over Proxy Votes. Several research reports and academic studies have catalogued the influence of proxy advisory firm recommendations on shareholder votes. For example:

- ISS clients typically control 20 to 30 percent of a midcap to large cap company's outstanding shares, while Glass Lewis clients typically control 5 to 10 percent, according to Innisfree MA.[6]
- Opposition by a proxy advisor resulted in a "20% increase in negative votes cast" according to a 2012 study by David F. Larcker, Allan L. McCall and Gaizka Ormazabal.[7]

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[5] Institutional Shareholder Services, 2012-2013 Policy Survey Summary of Results (Sept. 2012), at 2, http://www.issgovernance.com/files/private/ISSPolicySurveyResults2012.pdf.

[6] Yin Wilczek, *Bounty Program to Cramp Corporate Boards: ABA Speakers Discuss Governance Provisions,* DAILY REPORT FOR EXECUTIVES, Aug. 10, 2010.

[7] David F. Larker, *The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, November 12, 2012, http://blogs.law.harvard.edu/corpgov/2012/11/12/the-economic-consequences-of-proxy-advisor-say-on-pay-voting-policies/ (last visited June 3, 2013).

- An academic study found that a negative vote recommendation by ISS on a management proposal resulted in a reduction in affirmative votes by 13.6 percent to 20.6 percent.[8]

One of the most notable changes in proxy votes over the last three years has been the introduction of annual nonbinding votes on executive compensation. The Larcker research mentioned above found that among 2,008 firms in the Russell 3000, "firms that received a negative recommendation by ISS (Glass Lewis) obtained an average 68.68% (76.18%) voting support in SOP proposals. In contrast, firms that did not receive a negative recommendation from ISS (GL) obtained an average of 93.4% (93.7%) support in those proposals."[9]

The Larcker research is generally consistent with Center research. As of May 31, 2013, S&P 500 companies holding say on pay votes which experienced a change in recommendation from "For" in 2012 to "Against" in 2013 experienced a decrease in support of 26.4 percent, while companies receiving a positive recommendation received 93 percent approval on average. This is nearly identical to the results from the complete 2012 proxy season. The data shows a strong link between the ISS recommendation and the resulting votes.

Influence of ISS Voting Policies on Corporate Executive Compensation Programs. The voting results do not fully capture changes that companies make to their compensation policies in order to "score" better under proxy voting policies, particularly those of ISS. In a 2010 survey conducted by the Center and HR Policy Association, 54 percent of respondents said they had changed or adopted a compensation plan, policy or practice in the past three years primarily to meet the standard of a proxy advisory firm. A 2012 survey by the Conference Board, NASDAQ and the Stanford University Rock Center for Corporate Governance found that over 70 percent of directors and executive officers stated that their compensation programs were influenced by proxy advisory firm policies or guidelines.[10]

The Larcker research also looked at the impact of these preemptive changes on the risk-adjusted return investors earned after such changes by analyzing companies that announced compensation changes prior to the say on pay vote in an 8-K filing. The study found that "the average risk-adjusted return on the 8-K filing date is a statistically significant -0.42%.[11] Moreover, this effect is unique to 8-K changes in the time period before [the say on pay vote] and similar results are not observed for earlier time periods."[12] Based on this research, excessive focus on the recommendations of proxy advisors not only appears detrimental to share price, it is likely moving companies away from sound pay for performance strategies, as discussed below.

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[8] Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting,* FINANCIAL MANAGEMENT 29, 30 (Winter 2002).
[9] Larker *supra* note 4.
[10] The Conference Board, *The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions* (2012), https://www.conference-board.org/retrievefile.cfm?filename=TCB-DN-V4N5-12.pdf&type=subsite.
[11] Larker *supra* note 4.
[12] *Id.*

Example of the Negative Impacts of Proxy Advisory Firm Influence in Light of Say on Pay. Prior to say on pay taking effect, there was significant concern about the influence of proxy advisory firms in combination with the say on pay vote around the time say on pay was passed. For example, former TIAA-CREF General Counsel and current Chairman of Governance for Owners USA Inc., Peter Clapman, indicated "the inevitable consequence [of adopting say on pay] would be to transfer considerable discretionary power over individual company compensation practices to the proxy advisory firms. I question that such an approach will serve the long-term best interests of shareholders." Likewise, Columbia Law Professor Jeffrey Gordon indicated that "the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs."[13]

A prime example of how the mandatory say on pay vote has transferred considerable power to proxy advisory firms, as Mr. Clapman indicated, is the three-part quantitative pay for performance test ISS uses to initially determine its say on pay vote. The Relative Degree of Alignment test, which is accorded the greatest weight under the quantitative test, measures whether CEO pay and total shareholder return for the subject company is aligned with CEO pay and total shareholder return for the peer companies selected by ISS over one and three years. The way pay and TSR are measured under the test is likely to identify some companies whose pay and performance are aligned as not being aligned and vice-versa because the time periods for assessing pay and performance are inconsistent, and the analysis is over weighted toward one-year pay and performance.

- Mix of Actual and Hypothetical Pay. Under the Relative Degree of Alignment Test, pay is defined as total pay in the Summary Compensation Table of the proxy statement, which is a mix of actual and hypothetical pay. Specifically, total pay consists of compensation actually paid in the form of actual salary, annual incentive and/or bonus and long-term cash incentives, and the accounting estimates of equity compensation and other compensation.
- Inconsistent Time Periods Used to Assess Pay and Performance. Under the test, performance is defined as total shareholder return over one- and three-years. However, for most CEOs the majority of compensation is paid in the form of equity incentives which are granted and valued within two and half months of the *beginning* of the fiscal year being reported, while ISS measures total shareholder return as of the *end* of the fiscal year. In making the grants, the compensation committee would not have known the TSR as of the end of the year. Under the assessment, pay and performance are not likely to be aligned because the time period for the bulk of pay (equity compensation) and the time period for performance are not consistent. A more logical approach would be to compare the TSR from the end of the fiscal year preceding the reporting year so that pay and performance would be more closely aligned.

[13] Jeffrey Gordon, *'Say on Pay': Cautionary Notes on the UK Experience and the Case for Shareholder Opt-In* 325 (Columbia Law & Economics Working Paper No. 336; European Corporate Governance Inst. Working Paper No. 117/2009, Aug. 2009).

- Assessment Double Counts One Year Pay and Performance. The ISS analysis compares one-year TSR against one-year total CEO pay (weighted 40 percent) and three-year TSR against CEO pay over three years (weighted 60 percent). Consistent with a view of most institutional investors, the Center supports a longer term view of pay versus performance. However, the Center believes that the analysis proposed by ISS effectively double counts the one-year pay for performance measurement because the most recent year of pay and performance is counted under both the one-year and three-year TSR/pay comparison. One-year TSR is typically not very helpful in assessing performance due to short-term fluctuations of Wall Street, yet the ISS approach pushes toward a shorter-term orientation rather than a view of long-term pay for performance.

The ISS Relative Degree of Alignment test has led some companies to revise pay programs to try to get a better score, regardless of whether the approach is soundly aligned with company strategy. It has also led companies to experiment with alternative pay disclosures to tell their pay for performance stories directly to investors and to show more clearly that pay is aligned. The SEC's forthcoming requirement for the disclosure of pay actually received versus financial performance will likely force a discussion over similar time frames for assessing pay and performance among the proxy advisors.

III. The Regulatory Framework Has Reinforced Proxy Advisory Firm Influence

Proxy advisory firms have grown influential due in large part to two regulatory pronouncements, one by the U.S. Department of Labor, which announced the proxy voting duties of ERISA retirement plan sponsors in a 1988 opinion letter, and SEC rules, published in 2003. The DOL letter, commonly known as the "Avon Letter," stated that shareholder voting rights were considered valuable pension plan assets under ERISA, and therefore the fiduciary duties of loyalty and prudence applied to proxy voting. The Avon Letter stated:

> In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department's position that the decision as to how proxies should be voted ... are fiduciary acts of plan asset management.[14]

The Avon Letter further stated that pension fund fiduciaries, including those that delegate proxy voting responsibilities to their investment managers, had a responsibility to monitor and keep accurate records of their proxy voting.[15]

The SEC further reinforced the concept of fiduciary duties related to proxy voting in 2003 by adopting a rule and amendments under the Investment Advisers Act of 1940 pertaining to mutual funds and investment advisers designed to encourage funds to vote their proxies in the best interests of their shareholders.[16] The new regulations required

[14] Letter from Allan Lebowitz, Deputy Assistant Sec'y of the Pension Welfare Benefits Admin. at the U.S. Dep't of Labor, to Helmuth Fandl, Chairman of the Ret. Bd., Avon Products, Inc. (Feb. 23, 1988).
[15] *Id.*
[16] Sec. Exch. Comm'n, Final Rule: Proxy Voting by Investment Advisers, Advisers Act Release No. 1A-2106, 17 C.F.R. § 275 (Jan. 31, 2003).

mutual funds to: 1) disclose their policies and procedures related to proxy voting and 2) file annually with the Commission a public report on how they voted on each proxy issue at portfolio companies.[17]

Similarly, investment advisers were required to: 1) adopt written proxy voting policies and procedures describing how the adviser addressed material conflicts between its interests and those of its clients with respect to proxy voting and how the adviser would resolve those conflicts in the best interests of clients; 2) disclose to clients how they could obtain information from the adviser on how it had voted proxies; and 3) describe to clients all proxy voting policies and procedures and, upon request, furnish a copy to them.[18]

As part of the 2003 regulations, the SEC also commented on how investment advisers could deal with conflicts of interest related to proxy voting that might arise between advisers and their clients, stating that "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party."[19] In practice, this commentary provided a considerable degree of fiduciary "cover" to investment managers who chose to follow the voting recommendations of proxy advisory firms and reinforced the value of using such firms. In a letter to Egan-Jones Proxy Services in May 2004, however, the SEC articulated a duty for investment advisers to monitor and verify that a proxy advisor was independent and free of influence:

> An investment adviser that retains a third party to make recommendations regarding how to vote its clients' proxies should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances. A third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone's interest other than the adviser's clients.[20]

Although the intent of the SEC's 2003 rules was to provide a flexible means for mutual funds to execute proxy votes in the discharge of their clients' fiduciary duties, in reality it allowed mutual funds to shift that duty to proxy advisory firms. This led then Delaware Court of Chancery Vice Chancellor Leo Strine to remark that "[t]he influence of ISS and its competitors over institutional investor voting behavior is so considerable that traditionalists will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."[21]

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[17] *Id.*
[18] *Id.*
[19] *Id.*
[20] Letter from Douglas Scheidt, Associate Director and Chief Counsel, Sec. Exch. Comm'n, to Kent Hughes, Managing Director, Egan-Jones Proxy Services (May 24, 2004).
[21] Leo E. Strine Jr., *Toward a True Corporate Republic: A Traditional Response to Lucian's Solutions for Improving Corporate America*, Harvard Law School John M. Olin Center for Law, Economics and Business, Discussion Paper Series, No. 541, 11 (2006), http://lsr.nellco.org/harvard_olin/541.

IV. Conflicts of Interest and Inaccuracies Undermine Confidence in Proxy Advisory Firm Processes

Proxy advisors are currently afforded a considerable degree of deference under SEC interpretations because superficially they are considered "independent" of the investment advisors that use their services. Yet proxy advisory firms have significant conflicts of interest in the services they provide and in how they are structured. These conflicts have been the subject of two reports by the federal government's auditing arm, the U.S. Government Accountability Office (GAO), and they have been frequently criticized by companies and institutional investors. They also were the subject of questions in the SEC's concept release on the U.S. proxy system.

ISS Provides "Independent" Analysis of Company Practices While Offering Consulting Services to Those Same Companies. Despite frequent criticism by the government and others over the past 16 years, ISS, the largest and most influential firm, continues to provide analyses and voting recommendations of proxy issues to be put to a shareholder vote while also providing consulting services to corporations whose proposals they evaluate. This led the GAO to note that "corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings."[22] Similarly, a report by the Yale Millstein Center for Corporate Governance, stated that the many companies believe that "signing up for [ISS] consulting provides an advantage in how the firm assesses their governance" despite ISS disclaimers to the contrary.[23]

ISS also provides consulting to its institutional investor clients who wish to offer a shareholder proposal on how to tailor the proposal.[24]

These practices have been criticized by both institutional investors and corporations because ISS determinations and related consulting often drive what is considered best practice, even if the practice may not be in the best interest of the companies or their shareholders. ISS acknowledges this fact in its 2012 10-K filing, stating "when we provide corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that the Governance business team providing research to our institutional clients may treat that corporation more favorably due to its use of services provided by ISS Corporate Services."[25]

ISS has argued that it provides a firewall between its corporate consulting and its advisory businesses, but the separation can only go so far. For example, ISS seeks to reinforce the separation by telling corporate clients that when they meet with proxy

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[22] U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765, 10 (2007).
[23] Meagan Thompson-Mann, *Voting Integrity: Practice for Investors and the Global Proxy Advisory Industry* 9 (Yale Sch. of Mgmt. Millstein Ctr. for Corporate Governance & Performance, Policy Briefing No. 3, 2009).
[24] *Id.* at 12.
[25] MSCI Inc. Annual Report (Form 10-K) at 28, March 1, 2013, http://www.sec.gov/Archives/edgar/data/1408198/000119312513087988/d448124d10k.htm.

analysis staff, they should refrain from discussing whether the client has received consulting services from the other side of ISS. That said, according to the ISS 2012 10-K, revenues related to its consulting businesses had grown to 25.1 percent of the total revenue of its governance business.[26]

Potential Conflict Related to Proxy Advisory Firms Providing Recommendations on Shareholder Initiatives Backed By Their Owners or Institutional Investor Clients. Some proxy advisory firm clients are also proponents of shareholder resolutions. According to the Government Accountability office, "[t]his raises concern that proxy advisory firms will make favorable recommendations to other institutional investor clients on such proposals in order to maintain the business of the investor clients that submitted these proposals."[27] Other than boilerplate language, there is no specific identification that a shareholder proponent is an ISS client.

Conflicts in Ownership Structures. The largest proxy advisory firms have potential conflicts in their ownership structures that could cast significant doubt on their independence, including:

- ISS is owned by a larger public company, MSCI, Inc., that provides a wide range of indices and analytics to institutional investors and corporations. The ownership by a larger company could result in MSCI putting pressure on ISS to be more favorable to certain companies to procure their business.
- Glass, Lewis & Co. (the second largest advisor) is owned by the $100 billion Ontario Teachers' Pension Plan Board which engages in public and private equity investing in corporations on which Glass Lewis makes recommendations. Glass Lewis states that it will add a note to the research report of any company in which the Ontario Teachers' Pension Plan has a significant stake, the lack of transparency in the Glass Lewis model and the fact that it does not share draft reports with corporations has raised concerns about potential independence issues.

The potential ramifications of a proxy advisory industry with readily recognizable conflicts of interest that wields great power over capital markets and the market for corporate governance and control, which is subject to little regulatory oversight, mirror those that occurred in the credit ratings agency industry before the 2008 economic meltdown.

Inaccuracies in Proxy Advisory Service Reports and Lack of Transparent Methodologies Add to Skepticism Over Analytical Rigor In addition to questions about pay for performance methodologies and conflicts of interest is the problem with inaccuracies. This is significant because inaccurate information could lead institutional investors to voting decisions that are not supported by the facts.

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[26] *Id* at 8.

[27] U.S. GOV'T ACCOUNTABILITY OFFICE, CORPORATE SHAREHOLDER MEETINGS: ISSUES RELATING TO FIRMS THAT ADVISE INSTITUTIONAL INVESTORS ON PROXY VOTING, GAO-07-765, 10 (2007).

A 2010 survey of HR Policy Association members and Center On Executive Compensation Subscribers – chief human resource officers of large companies -- found that of those responding, 53 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs in 2009 or 2010.

Very recently, it was reported that ISS made a math error in its analysis for Eagle Bancorp in Bethesda, Maryland. ISS said the CEO's compensation increased between 2011 and 2012 when it actually *decreased* by 42 percent. ISS also double-counted some items in the CEO's total compensation. The company received 37 percent opposition to its say on pay vote, compared to 20 percent in 2012. The error was significant. Two institutional investors to whom Eagle spoke with changed their votes from no to yes. An article quoted the CEO as saying "What really upsets me more than anything else, if anybody had spent 10 seconds looking at the proxy, they would see that [our] proxy numbers are different from the ISS numbers. ISS should have asked why their numbers were different."[28]

Unfortunately, such errors are not uncommon, and it is the issuer that bears responsibility for checking the quality of the "expert" proxy advisory firm's assessment. For example, the Center is aware of another company that found a significant error by a proxy advisory firm. It took some time before the proxy advisory firm responded. Although the error was corrected and the proxy advisory firm changed the recommendation, the change was made within a week of the say on pay vote, and majority of shares had already been voted. The revised report made no explicit mention of the change on the front, and the clients would have had to review the notes at the very end of the report to see that the recommendation had been altered.[29]

Two principal reasons for such inaccuracies appear to be the workload pressures caused by the tremendous growth in the length of proxy disclosures and inadequate quality control, as publicly-held firms, such as ISS, seek to reduce costs by outsourcing proxy analysis to low labor-cost countries like the Philippines. Another reason for the inaccuracies is the unreasonably short time proxy advisors give large companies to review drafts of reports and to suggest corrections before a final report is issued.

The implications of these inaccuracies are worth the Subcommittee's attention. ISS has historically recommended voting against between 30 and 40 percent of all stock plans it reviews. It follows that if the Center data is representative of large companies generally, then proxy advisory firms could be negatively impacting the compensation programs at a meaningful number of companies because of institutional investors' reliance on the data.

The Center believes that proxy advisory firms should ensure to the greatest extent possible that accurate information is transmitted to institutional investors. Where information is found to be inaccurate, the proxy advisors should be required to correct

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[28] "Eagle Bancorp: Fuzzy Math Used for Say-on-Pay Recommendation," American Banker Online, May 31, 2013, http://www.americanbanker.com/people/eagle-bancorp-fuzzy-math-used-for-say-on-pay-recommendation-1059529-1.html?zkPrintable=true.
[29] *Id.*

their analyses and send the correction to their clients. Where there is a disagreement between the advisor and the company, the advisor should include a statement from the company discussing the rationale for its disagreement. Additionally, institutional investors should be required to closely monitor the output of proxy advisory firms, and the SEC should be required to do periodic reviews of advisor reports for accuracy and clarity.

V. 2012 Peer Group Push-Back Illustrates the Effectiveness of Regulatory Oversight

The Center believes that regulatory approaches to address the shortcomings discussed above should be carefully pursued. However, in the interim, it urges persistent and ongoing regulatory and legislative oversight of the proxy advisory firm industry to hold their policies and practices accountable and reinforce their duties to their clients and investors' fiduciary duties to their customers. An excellent example occurred last year with respect to the peer groups ISS used to determine its pay for performance comparisons. In many cases the peer groups did not fit with the size or industry of the company's business.

For example, ISS recommended investors vote against Marriott International's say on pay resolution, saying that its pay should not be compared with the pay of major competitors such as Hyatt Hotels Corporation or Starwood Hotels, even though Marriott requested that these companies be included. Instead, ISS chose AutoNation, Penske Automotive Group, Icahn Enterprises and Genuine Parts Co. as "appropriate" peers. In its supplemental filing, Marriott stated "we do not believe investors view these companies as similar in size and industry sector to our lodging management and franchise business. One selected peer, Penske Automotive Group, has a market capitalization that is less than 20 percent of Marriott's and another, Icahn Enterprises LP, is not a Russell 3000 company."[30] Ironically, the median compensation for the peer group selected for Starwood, a much smaller company, was more than 22 percent higher than ISS's selected peers for Marriott. In the end, shareholders saw through the ISS analysis and more than 87 percent approved the Marriott say on pay resolution—much better than many other companies receiving a negative ISS recommendation.

There were many other examples of companies where the peer group was a primary issue in the ISS say on pay recommendation and the vote as a whole. In fact, according to Semler Brossy Consulting Group, a majority of supplemental filings (23 of 45) for the S&P 500 involved peer group issues, most often, ISS.[31] Several examples of questionable peers were published in business press, including three articles in the *Wall Street Journal*.

However, the inquiries did not stop there. In our discussions with institutional investors last spring, several indicated that they questioned ISS's peer group selection. At least one indicated that they ran the peers by their portfolio managers, who also questioned the selections.

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[30] Marriot International, Inc., Current Report (Form 8-K) at 28, April 17, 2012, http://www.sec.gov/Archives/edgar/data/1048286/000119312512166311/d335747ddefa14a.htm

[31] Semler Brossy, 2012 Say on Pay Results Year-End Report, December 31, 2012, last viewed at http://www.semlerbrossy.com/wp-content/uploads/2013/01/SBCG-SOP-Year-End-Report.pdf.

The attention in the popular press, by investors, and many of the groups at this table, led then-SEC Director of Corporation Finance, Meredith Cross to invite companies to send their examples to the SEC or otherwise communicate with the staff regarding concerns about peer groups or proxy advisory firms generally.[32] The sentinel effect of that process reinforced the concerns in the marketplace, and ISS recognized by late spring that it would need to make changes to its peer group process, which it did. Although the Center believes that interpretive guidance or regulations from the SEC would help reinforce proxy advisory firm accountability, the 2012 example highlights the fact that targeted oversight in response to industry or investor comments can be as effective in addressing practices not in the best interests of shareholders and issuers.

VI. Recommendations

The Center believes that both non-regulatory and regulatory alternatives should be considered with respect to proxy advisory firms, given the power they exert over company practices and pay policies. However, we are concerned that a regulatory approach may entrench ISS and Glass Lewis and give the firms a government seal of approval. With these concerns in mind, we recommend the following objectives be pursued through oversight by Congress, the SEC and the U.S. Department of Labor.

- Greater Ongoing Oversight of Proxy Advisory Firm Operations. Oversight of proxy advisory firm policies should be subject to a regular system of oversight to ensure concerns from investors and issuers are met.

- Full Disclosure of Conflicts. Financial relationships and conflicts in the proxy advisory industry should be made transparent to investors. Targeted conflicts should include significant financial or business relationships between proxy advisory firms, or their parent or affiliate firms and public companies, institutional investors or shareholder activists. Such disclosure would throw open to public scrutiny and academic study a wealth of information about potential conflicts of interest in the industry. Investors and academic researchers could study whether corporate shareholder votes are being "bought and sold" and the extent to which fees paid to proxy advisory firms are, in fact, influencing vote recommendations. Such scrutiny would quickly provide concrete evidence whether the "Chinese walls" and other safeguards the industry has instituted are effective in mitigating the conflicts. Proxy advisory firms that provide assistance to institutional investor clients sponsoring a shareholder proposal should recuse themselves from making a recommendation on the proposal.

- Disclosure of Voting Methodologies. Both ISS and Glass Lewis should provide greater disclosure of the analytic processes, methodologies and models utilized to derive their voting recommendations. For instance, proxy advisory firms that utilize pay-for-performance compensation models to determine recommendations on compensation plans or advisory say on pay votes should be required to

[32] The Wall Street Journal, *SEC Plans New Guidance on Proxy Advisors*, June 7, 2012, http://blogs.wsj.com/cfo/2012/06/07/sec-plans-new-guidance-on-proxy-advisers/

publicly disclose all inputs, formulas, weightings and methodologies used in these models. Such disclosure would allow issuers and investors to effectively assess the merits and weaknesses of such models and to provide feedback to proxy advisory firms on these models.

- SEC Monitoring of Recommendations. The SEC should implement periodic reviews of proxy firm research reports to check for accurately and completeness, much the way the SEC currently does for company filings.

Conclusion

The Center appreciates the opportunity to provide its views on this extremely important policy matter. We look forward to working with you and members of your staffs to ensure that the proxy voting system and advice by proxy advisory firms are increasingly transparent and consistent.

A Call for Change in the Proxy Advisory Industry Status Quo

The Case for Greater Accountability and Oversight

January 2011
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About the Center On Executive Compensation

The Center On Executive Compensation is a research and advocacy organization dedicated to developing and promoting principled pay and governance practices and advocating compensation policies that serve the best interests of shareholders and other corporate stakeholders. The Center is a Division of the HR Policy Association, which represents the chief human resource officers of more than 300 of the largest corporations in the United States.

Acknowledgements

The Center On Executive Compensation would like to thank Scott Fenn for his considerable work as the primary researcher, writer and editor of this paper. His experience and expertise were invaluable in helping the Center staff to understand and articulate how the proxy advisory industry operates. That said, all conclusions and recommendations in the paper are the Center's and should not be attributable to Scott or any other individual or organization.

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I. Introduction

Each year, institutional investors cast billions of votes that determine corporate directors, executive compensation and corporate governance policies at more than 8,000 publicly traded U.S. companies. By law, the institutions have a fiduciary duty to vote in the best interests of their clients. However, with the gaggle of votes they are required to make, many institutions essentially outsource the analysis and process of developing voting recommendations to a handful of third parties called proxy advisory firms and some firms delegate the actual proxy voting to such firms. With the exponential increase in institutional assets over the past 20 years, the proxy advisory industry has quietly grown extremely powerful. It exercises a considerable degree of influence and control over corporate governance and executive compensation standards and its power is concentrated with one firm dominating the industry. Despite its considerable clout, the proxy advisory industry is scarcely regulated. As a result, the characteristics of the industry bear an uncanny resemblance to the credit ratings industry before the financial crisis:

- advisory firms have considerable conflicts of interest in how they are structured;
- the lack of transparency of the advisory firms' analytical models makes it extremely difficult for investors or companies to determine why a proxy advisor has made certain determinations or to correct factual inaccuracies before a vote is held; and
- concerns have mounted that inaccurate information is being transmitted to investors and all this is happening just as the influence of the industry is poised to increase as a result of changes in the just-passed financial reform bill.

The purpose of this paper is to provide essential background information on the development of the proxy advisory industry, expose the conflicts of interest and procedural lapses that could result in inaccurate proxy votes, review regulatory approaches to date, and suggest a workable approach to regulation of the industry.

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II. Executive Summary

Over the last quarter century, a confluence of developments has served to aggregate tremendous power among a small group of proxy advisory firms. These factors include:

- An increase in institutional stock ownership of the 1,000 largest corporations from 47 percent in 1987 to 76 percent in 2007, thus concentrating voting power in institutions, rather than retail investors.
- With this increase in institutional investor ownership has come an increase in ownership by state pension funds, which tend to be more progressive in their activism and frequently rely more heavily on the recommendations of proxy advisors.
- Increases in the volume of proxy votes, as the SEC expanded the subjects on which it permitted shareholder proposals and the growth of equity indexing. These changes required institutions to develop a voting position on more issues. Reflecting this growth, Broadridge Financial Solutions reported a 14 percent increase in the number of shares it processed between 2009 and 2010, from 309 billion shares to 350 billion shares processed.
- Regulatory mandates that pension funds and other institutional investors have a fiduciary duty to vote their proxies in the best interest of their clients. A 1988 Department of Labor interpretive letter reinforced this requirement with respect to pension funds, and a 2003 SEC rulemaking reinforced the requirement with mutual funds and investment advisors.
- A 2003 SEC interpretation that indicated that investment advisors could discharge their duty to vote their proxies and demonstrate that their vote was not a product of a conflict of interest if they voted client securities in accordance with a pre-determined policy and based on the recommendations of an independent third party (e.g., a proxy advisory firm).

The expansion of proxy voting, along with the regulatory interpretations, have caused the vast majority of institutional investors to separate the individuals making investment decisions from those making proxy voting decisions. As a whole, this has increased the influence of proxy advisory firms since institutional investors rely to a much greater extent on proxy advisors' analyses and voting recommendations.

Academic Research Shows Proxy Advisors Wield Exceptional Clout

The market for proxy advisory services has developed in such a way that one firm, Institutional Shareholder Services (ISS), largely controls the market, with a 61% market share,[1] and a second, Glass, Lewis & Co. controls approximately 37% of the market.[2] This concentration has allowed the firms to have a significant impact on pay and governance policy. For example, with regard to ISS, the dominant proxy advisory firm, academic research has shown that:

- a negative recommendation on a management proposal can reduce the support of institutional investors by up to 20 percent,[3] causing ISS to be the *de facto* pay and governance police and
- ISS's vote recommendations in contested director elections are "good statistical predictors of contest outcomes," in part because they influence investors to revise their assessment of board nominees.[4]

The academic research on the influence of proxy advisors is bolstered by evidence from firms that closely monitor institutional voting.

Recent statistics from the proxy solicitation firm Innisfree M&A, for instance, found that ISS clients typically control 20 to 30 percent of a midcap or largecap company's outstanding shares, while Glass Lewis clients typically control 5 to 10 percent.[5] The primary reason for the influence of these firms is simple: under SEC interpretations the advisory firms are considered independent experts, and if institutional investors rely on the recommendations made by them, they are held to have discharged their fiduciary duties to vote in the investors' best interests. Reflecting this point, the Honorable Leo E. Strine, Jr., Vice Chancellor of the Delaware Court of Chancery, commented that "the influence of ISS and its competitors over institutional investors' voting behavior is so considerable that traditionalists will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."

The level of influence wielded by proxy advisors on compensation issues was highlighted by a recent survey of 251 companies by consulting firm Towers Watson, which found that 59 percent of respondents believed that proxy advisors have significant influence on executive pay decision-making processes at U.S. companies. Similar results were obtained in a 2010 survey

by the Center On Executive Compensation, where 54 percent of survey respondents said they had changed or adopted a compensation plan, policy or practice in the past three years primarily to meet the standards of a proxy advisory firm.

Influence of Proxy Advisors Will Increase With the Adoption of Say on Pay and Other Policy Changes

The executive compensation and corporate governance provisions in the Dodd-Frank Act, the new financial reform law, will have the unintended consequence of further increasing the power and influence of proxy advisory firms. This is particularly the case with "say on pay" -- the new requirement that shareholders have a periodic nonbinding vote on executive compensation at least once every three years. This requirement will substantially increase the number of proxy votes on ballots annually and cause many institutional investors to defer to the proxy advisory firms' analysis as to whether a company's executive compensation program should be supported or opposed. Although institutional investors may have custom proxy voting policies, the basis for many, if not most, of these policies is the advisory firms' base policies. Without a viable alternative in the marketplace, the advisors' recommendations will determine whether a say on pay vote obtains substantial support.

This concern has been echoed by many different commentators, including:

- Former TIAA-CREF General Counsel and Current Governance for Owners U.S. Chairman, Peter Clapman, who indicated "the inevitable consequence [of adopting say on pay] would be to transfer considerable discretionary power over individual company compensation practices to the proxy advisory firms. I question that such an approach will serve the long-term best interests of shareholders."
- Edward Durkin, Director of Corporate Affairs for the Carpenters Union: "If you have an annual say on pay vote and you exercise your voting responsibility as we do ... it'd be overwhelming," said Durkin, whose union owns stakes in 3,500 companies.[6]
- Columbia Law Professor Jeffrey Gordon, who indicated that "the burden of annual voting would lead investors, particularly institutional investors, to farm out evaluation of most pay plans to a handful of proxy advisory firms who themselves will seek to economize on proxy review costs."[7]

In addition, because Dodd-Frank also requires shareholders to vote on how frequently a say on pay vote will occur – every one, two or three years – proxy advisors have a built-in preference to hold advisory votes every year because of the reliance that institutional investors will place on their analyses. Prior to the adoption of Dodd-Frank, the ISS methodology expressed a preference for an annual say on pay vote, and if a company's compensation plan conflicted with its policies, ISS indicated that it would recommend against the pay plan. It also stated "if there is no MSOP on the ballot, then the negative vote will apply to members of the compensation committee." ISS has confirmed that it will use this approach in the 2011 proxy season, even though the law clearly allows shareholders to express their preferences for a biennial or triennial say on pay vote.

The proxy advisors will also have significant influence over the say on pay vote required on change-in-control payments in merger and acquisition situations, which is required by Dodd-Frank.

A number of other changes in the Dodd-Frank Act are likely to increase the influence of the proxy advisory firms. These include:

- **Elimination of Broker Discretionary Voting.** Broker-dealers historically had the ability to vote their clients' shares, if the broker did not have specific voting instructions from the client. Broker discretionary votes have typically been cast in favor of management and can comprise up to 20 percent of the votes at some companies. However, without a significant increase in retail voter participation, it is unlikely that those shares will be voted at all, effectively disenfranchising a significant subset of shareholders and increasing the influence of institutional shareholders and thus the proxy advisory firms.

- **Proxy Access for the Nomination of Directors.** The Dodd-Frank Act gave the SEC authority to promulgate a rule allowing certain shareholders to nominate candidates to a company's board of directors, and the SEC approved such a rule roughly one month after Dodd-Frank became law. The validity of the rule is being challenged in federal court, and its implementation has been suspended pending the court's ruling. However, if the rule is ultimately upheld, the long-term impact will be to increase the number of contested elections on which institutional investors need to vote. As one organization of corporate pension plan sponsors commented, "these new proxy access standards will give [the proxy advisory firms] even greater power over the election of the boards of directors."[8]

Without greater oversight of the proxy advisory firms from the SEC and institutional investors, these changes will have a measurable impact on the influence the proxy advisors wield over the proxy process to the detriment of retail investors.

The Impact of Majority Voting for Directors. Another important change that has increased the influence of proxy advisory firms over institutional investors is the change from plurality voting for directors to majority voting for directors. Since 2004, amendments to the Model Business Corporation Act, Delaware General Corporation Law and shareholder campaigns have helped facilitate the adoption of majority voting for directors, with over two-thirds of companies in the S&P 500 Index using majority voting. Under majority voting, a candidate must receive a majority of votes cast in order to be elected, and thus a candidate in an uncontested election receiving less than a majority of votes cast is not considered elected. This contrasts with the historic practice of plurality voting for directors, in which the director to receive the most votes, without regard to withheld votes, won. With majority voting, recommendations from proxy advisory firms to withhold a vote or vote against a director could result in the failure to get elected.

The influence of the proxy advisors under majority voting is considerable and, in many cases, the recommendation to vote for or against a director is based upon the firms' analysis of the company's compensation and governance practices. It is therefore important that the advisors' policies and methodologies used for analyzing company practices be free from conflicts, errors, be transparent and be based upon sound compensation and governance understanding, which is regularly not the case.

The advent of majority voting provides shareholders and proxy advisors with a strong tool to hold directors accountable. However, before they can do so in a fashion that is in the best interests of shareholders and the proxy voting system as a whole, the advisors must be held accountable for the conflicts of interest and inaccuracies in analysis that are all too common.

Conflicts of Interest at the Largest Advisory Firms Cast a Shadow on the Integrity of Research and Voting Recommendations

Proxy advisors are currently afforded a considerable degree of deference under SEC interpretations because superficially they are considered "independent" of the investment advisors that use their services. Yet proxy advisors have significant conflicts of interest that raise serious questions about their independence. The largest proxy advisory firms have significant conflicts of interest in the services they provide and in how they are structured. These conflicts have been the subject of two reports by the federal government's auditing arm, the U.S. Government Accountability Office (GAO), and they have been frequently criticized by companies and institutional investors.

ISS Provides "Independent" Analysis of Company Practices While Offering Consulting Services to Those Same Companies. Despite frequent criticism by the government and others over the past 16 years, ISS, the largest and most influential firm, continues to provide analyses and voting recommendations of proxy issues to be put to a shareholder vote while also providing consulting services to corporations whose proposals they evaluate. This led the GAO to note that "corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings."[9] Similarly, a report by the Millstein Center On Corporate Governance, stated that the many companies believe that "signing up for [ISS] consulting provides an advantage in how the firm assesses their governance" despite ISS disclaimers to the contrary.[10]

Corporate governance expert Ira Millstein described the inherent conflict in the ISS model as follows:

> It provides structural "standards" for corporate governance, privately prepared by unidentified people, pursuant to unidentified processes, and asks us to take its word that it is all fair and balanced. I tried to dig behind the soothing assurances, but couldn't find enough detail to convince me that a devil didn't lie in the details of how this private standard-setting was put together. And then ISS provides company ratings, based on these privately-set standards, creating a tendency on the part of those that have received a poor rating to pay for a consultancy by the private standard-setter, on how to improve that rating. I see this as a vicious cycle.

This "vicious cycle" has been roundly criticized by both institutional investors and corporations because ISS determinations and related consulting drives what is considered best practice, even if the practice may not be in the best interest of the companies or their shareholders. Even ISS acknowledges this fact in its 2009 10-K filing, stating "for example, when we provide corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that we may treat that corporation more favorably due to its use of our services, including our Compensation Advisory Services, provided to certain corporate clients."[11]

ISS has argued that it provides a firewall between its corporate consulting and its advisory businesses, but the separation can only go so far. For example, ISS seeks to reinforce the separation by telling corporate clients that when they meet with proxy analysis staff, they should refrain from discussing whether the client has received consulting services from the other side of ISS.

Conflicts in Ownership Structures. The largest proxy advisory firms have potential conflicts in their ownership structures that could cast their independence into significant doubt, including:

- ISS is owned by a larger public company, MSCI, Inc., that provides a wide range of services to institutional investors and corporations. The ownership by a larger company could result in MSCI putting pressure on ISS to be more favorable to certain companies to procure their business. Glass, Lewis & Co. (the second largest advisor) is owned by the Ontario Teachers' Pension Plan which engages in public and private equity investing in corporations on which Glass Lewis makes recommendations. Although Glass Lewis states that it will add a note to the research report of any company in which the Ontario Teachers' Pension Plan has a significant stake, the lack of transparency in the Glass Lewis model and the fact that it does not share draft reports with corporations has raised concerns about potential independence issues;

As Julie Gozan, Director of Corporate Governance at union-owned Amalgamated Bank, commented: "The community that relies on Glass Lewis and ISS needs to know this is unbiased advice that favors long-term investors and not the interests of corporate executives. When these firms go public, there's real potential for a conflict of interest."[12] The conflicts of interests are not unique to the large firms, however. For example:

- Proxy Governance Inc., (the third largest proxy advisory firm until the end of 2010) was owned by a firm whose chief subsidiary is a registered broker-dealer, which could lead to divergent interests among clients of each firm;
- Egan-Jones is owned by a firm whose primary business is a credit ratings agency; and
- Marco Consulting, a proxy advisor whose clients are Taft-Hartley pension funds, may find itself pressured to recommend in favor of a shareholder proposal submitted by a client, even if contrary to its voting guidelines, to retain the client.

The potential ramifications of a proxy advisory industry with readily recognizable conflicts of interest that wields great power over capital markets and the market for corporate governance and control, which is subject to little regulatory oversight, mirror those that occurred in the credit ratings agency industry before the 2008 economic meltdown. These include: the existence of a quasi-regulatory license, conflicts of interest in the business model and the provision of ancillary services, and insufficient regulation. Ultimately, this caused Congress to establish a new regulatory framework for the credit ratings industry in the Dodd-Frank Act.

The Center believes that, at a minimum, the SEC should ban conflicts of interest in the proxy advisory firm industry in which a firm both provides so-called "independent" analyses of company practices for institutional investors while simultaneously offering consulting services to companies as to how to improve the company's assessment by the advisor. The Center also believes that the SEC should require greater disclosure of other conflicts, especially those created by the ownership structures of proxy advisory firms.

Inaccuracies in Proxy Advisory Service Reports and Lack of Transparent Methodologies Add to Skepticism Over Analytical Rigor

In addition to conflicts of interest, anecdotal information and survey data raise significant questions regarding whether there are increasing inaccuracies among the analyses published by the proxy advisory firms. This is significant because inaccurate information could lead institutional investors to voting decisions that are not supported by the facts.

A 2010 survey of HR Policy Association members and Center On Executive Compensation Subscribers – chief human resource officers of large companies -- found that of those responding, 53 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs in 2009 or 2010.[13] The three most frequent types of inaccuracies identified by companies included:

- improper use of peer groups or peer group data in determining whether executive compensation levels were appropriate which was reported by 20 percent of respondents;
- erroneous analysis of long-term incentive plans reported by 17 percent of respondents; and
- inaccurate discussion of provisions no longer in effect was reported by 15 percent of respondents.

Two principal reasons for such inaccuracies appear to be the workload pressures caused by the tremendous growth in the length of proxy disclosures and inadequate quality control, as publicly-held firms, such as ISS, seek to reduce costs by outsourcing proxy analysis to low labor-cost countries like the Philippines. Another reason for the inaccuracies is the unreasonably short time proxy advisors give companies to review drafts of reports and to suggest corrections before a final report is issued.

The implications of these inaccuracies are alarming. ISS has historically recommended voting against between 30 and 40 percent of all stock plans it reviews. It follows that if the Center data is representative of large companies generally, then proxy advisory firms are negatively impacting the compensation programs at a meaningful number of companies because of institutional investors' reliance on the data.

The Center believes that proxy advisory firms should ensure to the greatest extent possible that accurate information is transmitted to institutional investors. Where information is found to be inaccurate, the proxy advisors should be required to correct their analyses and send the correction to their clients. Where there is a disagreement between the advisor and the company, the advisor should include a statement from the company discussing the rationale for its disagreement. Additionally, institutional investors should be required to closely monitor the output of proxy advisory firms, and the SEC should be required to do periodic reviews of advisor reports for accuracy and clarity.

The Extent of Government Regulation Over the Proxy Advisory Industry Is Inadequate Given Its Influence Over the Proxy Voting Process

Proxy advisory firms are currently "regulated" by the SEC under the Investment Advisers Act of 1940, a statute written principally for firms that provide investment advice to companies or individuals. Various exemptions under the Act mean that proxy advisory firms can essentially choose whether to register with the SEC under the Act, and while additional regulatory and procedural requirements apply to those that do, the statute has been lightly enforced with respect to proxy advisors. Institutional investors, for their part, have seen proxy advisors as a cost-effective and efficient way to discharge and essentially outsource their own duties for voting proxies. Therefore, they have little incentive to change the system by closely monitoring the decisions and pointing out deficiencies in the quality controls of proxy advisors.

Proposals for Increased Oversight of the Proxy Advisory System Take a Step in the Right Direction

A number of proposals have been made to tighten regulation of the industry – ranging from mandating greater disclosure under existing rules to imposing new regulatory frameworks similar to those that apply to credit ratings agencies or public accounting firms. The new regulatory frameworks include requiring greater transparency of methodologies and filing voting recommendations with the SEC on a delayed basis, much like the mutual fund industry must currently file its proxy votes. These proposals are under consideration by the SEC, which requested public comment on the deficiencies in the proxy advisory firm industry and recommendations on how to address them. The Department of Labor went one step further in October 2010, by proposing regulations that would arguably impose ERISA fiduciary status on SEC-registered proxy advisory firms and possibly all proxy advisory firms. Many of these proposals have significant merit. However, there are also legitimate concerns that regulation could have unintended consequences – serving to credential and entrench existing proxy firms while creating barriers to entry for new firms.

Fostering Greater Competition in the Proxy Advisory Industry May Address Fundamental Problems

Proposals have been made to adopt a public utility model for the widespread provision of proxy recommendations or to develop client-directed voting platforms to enhance retail voting participation. If successful, such efforts have the potential to dilute the influence of proxy advisors by expanding the market for services providing expert voting recommendations. To be effective, such approaches would need to provide recommendations that institutional investors could rely on to assist in discharging their fiduciary duty to vote their proxies in the best interests of their clients.

Center Recommends Banning Worst Conflicts and Requiring Better Disclosure to Promote Market Reforms

The Center On Executive Compensation believes that the most effective approach for mitigating the issues surrounding the proxy advisory services involves the following basic reforms.

Ban on Worst Form of Conflict. The SEC should institute a ban on proxy advisory firms, or their affiliates, from providing advisory services to institutional investors, while at the same time providing consulting services to corporate issuers on matters subject to proxy votes. Pending the change, mandate disclosure by companies of the fees paid and services obtained from proxy advisors in the proxy statement.

Full Disclosure of Other Conflicts. The SEC should mandate disclosures designed to make other financial relationships and conflicts in the proxy advisory industry transparent to investors. Targeted conflicts should include significant financial or business relationships between proxy advisory firms, or their parent or affiliate firms, with public companies, institutional investors or shareholder activists. Such disclosure would throw open to public scrutiny and academic study a wealth of information about potential conflicts of interest in the industry. Investors and academic researchers could study whether corporate shareholder votes are being "bought and sold" and the extent to which fees paid to proxy advisory firms are, in fact, influencing vote recommendations. Such scrutiny would quickly provide concrete evidence whether the "Chinese walls" and other safeguards the industry has instituted are effective in mitigating the conflicts.

Disclosure of Voting Methodologies. The SEC should also mandate that proxy advisory firms disclose the analytic processes, methodologies and models utilized to derive their voting

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recommendations. For instance, proxy advisory firms that utilize pay-for-performance compensation models to determine recommendations on compensation plans or advisory say on pay votes should be required to publicly disclose all inputs, formulas, weightings and methodologies used in these models. Such disclosure would allow issuers and investors to effectively assess the merits and weaknesses of such models and to provide feedback to proxy advisory firms on these models.

Clarify Fiduciary Duties of Institutional Investors and Plan Sponsors. The SEC should provide additional guidance to investment advisers and plan sponsors making it clear that their fiduciary obligations to vote proxies in the interests of investors require diligent monitoring of the conflicts, practices and decision processes of third-party proxy advisors. The mere act of hiring a proxy advisor should not be seen as sufficient to allow institutions to meet their fiduciary obligations under ERISA. Moreover, these obligations should be vigorously enforced to provide a true incentive for institutions to take seriously their role in monitoring and influencing proxy advisory firm behaviors and policies.

SEC Monitoring of Recommendations. The SEC should implement periodic reviews of proxy firm research reports to check for accurately and completeness, much the way the SEC currently does for company filings.

This paper examines the above issues in depth. **Chapter III** discusses the historical factors that have concentrated voting power in the hands of proxy advisors – leading to a near-monopoly in the industry – and why recent financial regulatory developments will increase this power further. **Chapter IV** provides background on each of the proxy advisory firms and the services they provide. **Chapter V** explains the types of conflicts of interest that proxy advisory firms are subject to and how those conflicts parallel those which have engendered so much concern at credit ratings agencies. **Chapter VI** discusses concerns about the lack of transparency and inaccuracies in proxy analyses and presents survey research on these inaccuracies as they relate to compensation issues. **Chapter VII** outlines the existing regulatory and legal framework for proxy advisory firms. **Chapter VIII** discusses proposals for addressing problems in the industry through increased regulation as well as some concerns about potential unintended consequences from this approach. **Chapter IX** examines the potential for greater competition and other private sector solutions as mechanisms for addressing problems at proxy advisors. **Chapter X** summarizes the Center's recommendations.

III. The Rise of the Proxy Advisory Industry

The proxy advisory industry is receiving considerable scrutiny because, over the last three decades, it has grown to play an increasingly influential role in the U.S. and global proxy voting system – the principal means by which shareholders of corporations participate in corporate governance. That influence is poised to expand considerably in 2011, when each public company is required to hold a nonbinding shareholder vote on executive compensation.

The growing influence of the small number of firms providing proxy research and voting recommendations has been driven by tremendous growth in share ownership by institutional investors as well as the number of ballot items that institutions must vote on each year. From May 1, 2009, through April 30, 2010, for example, nearly 1 trillion shares were voted at more than 13,800 U.S. corporate issuers.[14] Going forward, recent important changes in regulations governing the financial industry, corporate governance and proxy voting seem destined to further increase the reliance of institutional investors on proxy advisors.

To understand the effect of these changes on the growth in influence of proxy advisory firms, it is important to understand the origins of the industry and how the growth in institutional assets has shaped it with relatively little federal oversight.

A. Origins of Shareholder Activism and the Proxy Advisory Industry

Shareholder activism has been around for over 400 years, dating back to a petition lodged against the Dutch East India Company by investor Isaac Le Maire.[15] In the United States, financial institutions, such as banks and mutual funds, were "activist" investors at many corporations in the early 1900s, with representatives of these financial institutions often serving on corporate boards and becoming involved in the strategic direction of the firm.[16] Modern U.S. shareholder activism is often traced to the 1942 adoption by the Securities and Exchange Commission of a shareholder proposal rule, granting shareholders the right to submit certain types of proposals for inclusion on corporate proxy ballots.[17]

Individual Investor Activism Predominated Until the Late 1980s. Early U.S. shareholder activism was dominated by individual investors who were often labeled "gadflies." In 1982, for example, nearly 30 percent of the 972 shareholder proposals submitted to companies were proposed by just three individuals.[18] Use of the shareholder proxy process by institutional investors began to grow in the mid-1980s, however, after the 1985 founding of the Council of Institutional Investors, originally a group of public and union pension funds interested in lobbying for greater shareholder rights.

Proxy Research Initiated by College Endowments Then Spread to Institutional Investors. The need for professional proxy research and analysis by institutional investors first manifested itself in the formation of the Investor Responsibility Research Center (IRRC) in 1972. IRRC was founded by a group of college and university endowments and foundations who wanted impartial research on social and environmental questions raised in proxy proposals. Later, in the early 1980s, as activists began to expand their use of shareholder proposals, IRRC expanded its services to include research on corporate governance issues and an electronic voting platform and soon had hundreds of institutional investors subscribing to its services. IRRC was organized as a not-for-profit corporation and, while it provided research reports on specific ballot items, it did not make vote recommendations.

Proxy voting recommendations were introduced to the market in mid-1980s with the founding of two private commercial companies – Proxy Monitor in 1984 and Institutional Shareholder Services (ISS) in 1985. These firms satisfied a demand from many institutional investors for proxy analyses that contained voting recommendations. Over time, ISS became an industry consolidator by buying or merging with several rival firms, including Proxy Monitor (in 2001) and IRRC (in 2005). Three other commercial proxy advisory firms soon entered the market to compete with ISS, with Glass, Lewis & Co. and Egan-Jones Proxy Services offering services in 2003, and Proxy Governance, Inc. launching a service in 2005.

B. Increases in Institutional Stock Ownership

Dramatic changes in the nature of equity ownership in the United States in the last half century have largely created the demand for proxy advisory services. Institutional investors – including pension funds, investment companies, mutual funds, insurance companies, hedge funds, banks, foundations and endowments – have greatly increased their ownership share of public companies relative to individual investors. At the end of

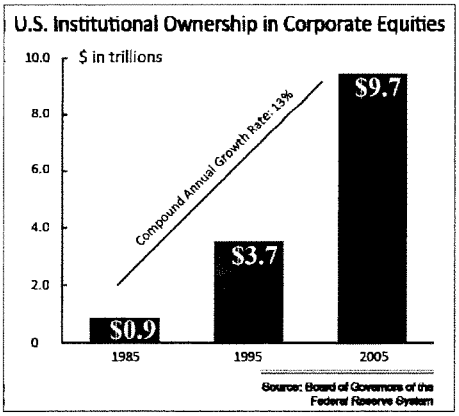
2007, levels of institutional stock ownership of the 1,000 largest corporations in the U.S. reached an all-time high of 76.4 percent, according to the Conference Board, up from an average of 61.4 percent in 2000 and 46.6 percent in 1987.[19]

Meanwhile, the percentage of equity shares held by retail investors has fallen to new lows, accounting for less than 24 percent of shares in the 1,000 largest corporations at the end of 2007, compared with 94 percent of all stocks in 1950, and 63 percent in 1980.[20] The impact of this decline in retail share ownership on voting is amplified by declining retail investor voting participation.

State and Local Pension Funds Fuel Equity Asset Growth and Activism. Among categories of institutional investors, the growth of equity assets under management by state and local public pension funds is important because these funds tend to be more progressive in their activism and frequently rely heavily on the recommendations of proxy advisors. According to Conference Board data, public pension funds increased their share of total equity assets from 2.9 percent in 1980 to 10 percent by the end of 2006, while private, trusteed funds (generally corporate pension plans) saw their share of total equity assets decline from 15.1 percent in 1980 to 13.6 percent in 2006.[21]

The dramatic growth in U.S. institutional ownership of corporate equities between 1985 and 2005 is illustrated below in Figure 1.

FIGURE 1:



C. Increases in the Volume of Proxy Votes

At the same time that equity assets held by institutional investors were burgeoning, the volume of proxy votes that many institutions needed to process grew tremendously. Proxy voting volumes were increasing due to several factors. An increase in the number of shareholder activists resulted in an increase in shareholder proposals due in part to changes in SEC rules expanding subjects that proposals could address. In addition, the growth of equity indexing meant that by the 1980s, many institutions began to hold thousands of equity securities in their portfolios, as opposed to the few hundred typically owned by "active" investment managers.[22]

The tremendous growth in proxy voting in recent decades shows little evidence of slowing down. During the 2010 proxy season (Feb. 15 – May 1), Broadridge Financial Solutions, the primary proxy vote processing firm, reported that it processed over 350 billion shares, up nearly 14 percent from over 308 billion in 2009.[23]

D. Investors' Fiduciary Duty to Vote Proxies

After the passage of the Employee Retirement Income Securities Act of 1974 (ERISA), the U.S. Department of Labor (DOL) began requiring private pension fund fiduciaries to act solely in the interests of their plan participants and beneficiaries. Subsequently, in 1988, DOL released a letter, commonly known as the "Avon Letter," stating that shareholder voting rights were considered valuable plan assets under ERISA, and therefore the fiduciary duties of loyalty and prudence applied to proxy voting. The Avon Letter stated:

> In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock. For example, it is the Department's position that the decision as to how proxies should be voted ... are fiduciary acts of plan asset management.[24]

The Avon Letter further stated that pension fund fiduciaries, including those that delegated proxy voting responsibilities to their investment managers, had a responsibility to monitor and keep accurate records of their proxy voting.[25]

The SEC further reinforced the concept of fiduciary duties related to proxy voting in 2003 by adopting a rule and amendments under the Investment Advisers Act of 1940 pertaining to mutual funds and investment advisers.[26] The new regulations required

mutual funds to: 1) disclose their policies and procedures related to proxy voting and 2) file annually with the Commission a public report on how they voted on each proxy issue at portfolio companies.

Similarly, investment advisers were required to: 1) adopt written proxy voting policies and procedures describing how the adviser addressed material conflicts between its interests and those of its clients with respect to proxy voting and how the adviser would resolve those conflicts in the best interests of clients; 2) disclose to clients how they could obtain information from the adviser on how it had voted proxies; and 3) describe to clients all proxy voting policies and procedures and, upon request, furnish a copy to them.[27]

As part of the January 2003 regulations, the SEC also commented on how investment advisers could deal with conflicts of interest related to proxy voting that might arise between advisers and their clients, stating that "an adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party."[28] In practice, this commentary provided a considerable degree of fiduciary "cover" to investment managers who chose to follow the voting recommendations of proxy advisory firms and reinforced the value of using such firms. In a letter to Egan-Jones Proxy Services in May 2004, however, the SEC articulated a duty for investment advisers to monitor and verify that a proxy advisor was independent and free of influence:

> An investment adviser that retains a third party to make recommendations regarding how to vote its clients' proxies should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances. A third party generally would be independent of an investment adviser if that person is free from influence or any incentive to recommend that the proxies should be voted in anyone's interest other than the adviser's clients.[29]

There remain serious concerns by some observers and regulators whether institutional managers are meeting their fiduciary duties with regard to proxy voting. For example, in two articles published in the Latham & Watkins LLP's *Corporate Governance Commentary,* Charles Nathan, co-chair of the firm's Corporate Governance Task Force, argues that the bifurcation that has occurred in the market between investment decision-makers and those responsible for proxy voting may not meet fiduciary standards:[30]

> The effectiveness of this model rests on the assumption that voting decisions can be delegated to specialists and third-party proxy advisors so as to fulfill the institution's fiduciary duties without imposing undue costs on the institution. It is not clear, however, that the parallel voting universe that has evolved over the past 25 years successfully discharges institutional investors' fiduciary duties of due care and loyalty.[31]

Although historically there has been very little SEC enforcement regarding fiduciary duties with respect to proxy voting, in recent years, the SEC has begun to show interest in the issue. In 2008, it issued a Compliance Alert letter that described some of the deficiencies it found in managers' proxy voting oversight and operations.[32] Then, in May 2009, it settled an enforcement action against an investment adviser and its Chief Operating Officer related to that adviser's proxy policies, procedures and failure to disclose to clients a material conflict of interest related to those policies.[33] In July 2010, the SEC asked for public comment on a concept release asking whether rules changes in the U.S. proxy system should be considered to promote greater efficiency and transparency.[34] Finally, in September 2010, the New York Stock Exchange Commission on Corporate Governance issued its final report which contained governance principles calling for proxy advisory firms to be held to appropriate standards of transparency and accountability and for institutional investors to vote their shares in a thoughtful manner and avoid a "'check the box mentality.'"[35]

E. Academic Research Shows Proxy Advisors Have a Significant Impact on Voting Outcomes

As the factors discussed above have driven investment managers to rely more heavily on proxy advisors, most large institutional investors have separated the persons making investment decisions from the process for voting proxies – either by delegating voting decisions to a separate internal group or by outsourcing some or all of the voting process to third-party proxy advisors.[36] Most industry observers concur that proxy advisors, particularly ISS, now have a significant influence on vote outcomes. This sentiment was summed up by Delaware Court of Chancery Vice Chancellor Leo E. Strine Jr., who stated, "[f]ollowing ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations."[37] In fact, Strine has written that "[t]he influence of ISS and its competitors over institutional investor voting behavior is so considerable that traditionalists will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind. . . ."[38]

While there is little doubt that the proxy advisors influence voting, a lively academic debate has emerged over exactly how many votes they can sway. Susan E. Wolf, former Vice President and Corporate Secretary at Schering-Plough and the former Chairman of the Society of Corporate Secretaries and Governance Professionals, has said that some of the organization's corporate members think that ISS alone controls one-third or more of their shareholder votes.[39] According to recent statistics from Innisfree M&A, a proxy solicitation firm, ISS clients typically control 20 to 30 percent of a midcap to largecap company's outstanding shares, while Glass Lewis clients typically control 5 to 10 percent.[40]

Academic Studies Attempt to Quantify ISS Influence. Several academic studies have been conducted attempting to quantify how much influence proxy advisors have on the outcome of issues brought to shareholder votes. In 2002, a study published in the journal, *Financial Management*, found that ISS recommendations had a substantial impact on voting results, with unfavorable ISS recommendations on management proposals linked to 13.6 percent to 20.6 percent fewer affirmative votes for management proposals depending on the specific proposal type.[41] Another academic study published by the European Corporate Governance Institute found that ISS recommendations were significantly related to the passage of management proposals.[42]

More recently, a study by three business school professors and a staff member of the SEC examined ISS voting recommendations in 198 contested elections from 1992 through 2005, where dissidents were seeking board seats.[43] The study found that ISS vote recommendations in such situations "are good statistical predictors of contest outcomes, even after controlling for a variety of contest, firm, dissident, and management characteristics."[44] In addition, the study found that ISS proxy recommendations seemed to play a "certification role" in influencing investors to revise their assessments of the quality of dissident board nominees.[45] Another study of the influence of four major proxy advisory firms in director elections concluded that, after controlling for the underlying factors that influenced advisory firm recommendations, "advisor recommendations in general, and ISS in particular, appear to be less influential than commonly perceived," with ISS voting recommendations directly swaying 6 to 9 percent of institutional votes.[46] Yet, even with this lower estimate, ISS's influence over large companies is frequently greater than the company's largest shareholder.

While the academic debate over exactly what percentage of votes each proxy advisor can influence on any given issue will no doubt continue, the fact that proxy advisory firms can influence or control a significant block of votes on corporate proxy issues is undeniable. Moreover, the perceived influence of proxy advisors by board members is just as important as the advisors' actual impact. As two White & Case lawyers who studied the industry recently concluded:

> [L]ittle doubt exists that proxy advisors, at a minimum, have had a meaningful impact on some shareholder votes, particularly those in connection with closely fought proposals. Moreover, if most directors believe that ISS has power – as their actions indicate – boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified. Similarly, if most institutional investors follow the same proxy advice closely, the impact of that advice on U.S. corporate governance could be very significant. For these reasons, it is incumbent on proxy advisors to operate with full transparency, ideally pursuant to self-imposed industry-wide standards that result in clear disclosure to institutional and retail investors alike in connection with voting recommendations.[47]

In the current environment where many proxy issues are increasingly being decided on very close votes, this fact reinforces the need to ensure the integrity of the process by which those advisors are making vote recommendations. Based on the conduct of the industry so far, self-regulation will not accomplish this goal.

F. Regulatory Changes Will Increase Further the Number and Influence of Proxy Votes

Recent significant changes in financial regulations promise to further increase the volume and impact of proxy votes and the influence of the proxy advisory firm industry. These changes include:

- the proliferation of majority voting;
- mandatory say on pay votes;
- elimination of broker discretionary voting in uncontested director elections and on compensation matters; and
- new SEC rules governing proxy access in the nomination of directors.

While the impact of any one of these changes on the power and influence of proxy advisory firms might not be overwhelming, the cumulative impact of all of them – and the way that these measures interact – is likely to dramatically increase the power of the proxy advisors and cause significant unintended consequences. This is

particularly significant, because there is no effective supervision of the proxy advisors beyond the minimal regulatory oversight associated with being an investment adviser for those firms that have voluntarily chosen to register as investment advisers.

The potential impact and significance of each of these key regulatory changes on the proxy advisory industry is discussed below.

Majority Voting. A fundamental right of shareholders under state corporate law is the right to elect corporate directors. Until several years ago, virtually all U.S. companies elected their directors using plurality voting. Under a plurality voting system, the director nominees who receive the most votes are elected up to the maximum number of directors to be chosen in the election without regard to votes "withheld," voted against or not cast. In an uncontested election, however, this system effectively means that a single vote cast "for" a nominee would be sufficient to win that nominee a board seat.

Beginning in 2004, a number of shareholder groups and union pension funds mounted campaigns to urge companies to embody a majority voting standard in their bylaws, corporate charters or governance documents. Under majority voting, a director typically needs to obtain support from a majority of the shares cast in order to be legally elected.[48] The United Brotherhood of Carpenters & Joiners of America (Carpenters Union) was among the early supporters of majority voting, submitting 12 shareholder proposals on the issue in 2004. In 2005, encouraged by the voting support for its proposals the previous year, the Carpenters Union and other building trade union funds submitted 89 proposals on majority voting of which 16 garnered majority support from shareholders.[49] Also in 2005, the Council of Institutional Investors launched a letter-writing campaign to 1,500 of the largest U.S. corporations requesting them to adopt majority voting in uncontested director elections.[50] In 2006, the Model Business Corporation Act (MBCA) and the Delaware General Corporation Law were amended to facilitate the adoption of majority voting by company boards or by shareholders.

Major public and union pension funds, such as the California Public Employees Retirement System (CalPERS) and American Federation of State, County and Municipal Employees (AFSCME), joined the majority voting campaign by submitting nonbinding shareholder proposals calling for the adoption of majority voting at dozens of companies, and these proposals have continued to attract strong support. In 2010, for instance, 19 proposals were submitted seeking the adoption of majority voting received majority shareholder support.[51]

Overall, the changes in Delaware law and the MBCA, as well as the shareholder campaigns in favor of adoption of a majority voting standard, have been quite effective, at least among the largest U.S. corporations. More than two-thirds of the companies in the S&P 500 Index have now adopted some form of majority voting – making it the de facto standard among large corporations.[52]

The impact of the widespread adoption of majority voting is to greatly increase the leverage that investors (and hence proxy advisory firms) have over corporate directors. Because most shareholder proposals are advisory in nature, some companies have chosen not to implement specific proposals with which they disagree, even when those proposals have been supported by a majority of shareholders.[53] A number of proxy advisory firms and investors have reacted to such company decisions not to implement majority shareholder-supported governance measures by "withholding" votes from incumbent directors up for election at these companies. Under plurality voting elections, such "no vote" campaigns or recommendations were essentially symbolic. Under new majority voting regimes, however, they have the potential to unseat directors – or at a minimum put boards in the awkward position of explaining why they should override the wishes of a majority of their shareholders.

Shareholder Say on Pay and Related Compensation Votes. In recent years, a relatively small number of U.S. companies, under pressure from shareholder campaigns, have voluntarily implemented nonbinding shareholder votes on executive compensation (commonly referred to as say on pay votes). Reflecting the platform of the Obama Administration, Congress embraced the idea, first by making annual say on pay votes mandatory for all U.S. companies that were recipients of taxpayer funds under the Troubled Asset Relief Program (TARP), which was signed into law in October 2008.[54] It expanded say on pay to all U.S. public companies in the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was enacted on July 21, 2010.[55]

Although nearly 200 shareholder proposals requesting that individual companies adopt an advisory say on pay vote had been filed since between January 2006 and October 2010, collectively, these resolutions received majority support from shareholders less than 30 percent of the time.[56] What activists had difficulty achieving through company votes, they achieved through legislation. Section 951 of the Dodd-Frank Act requires corporations to hold a nonbinding shareholder say on pay vote at least once every three years to "approve" executive compensation

as disclosed in the proxy statement. In addition, the Act requires a separate shareholder vote at least once every six years to determine whether such say on pay votes should be held annually, biennially or triennially. The new requirements apply to shareholder meetings which occur after January 21, 2011, meaning virtually all companies will have to hold a "say on pay" and a "frequency" vote during the 2011 proxy season.

The Dodd-Frank Act includes several other provisions that will enhance the power of proxy advisors. These include a requirement that executive compensation payments related to a sale, merger, acquisition or other disposition of assets requiring shareholder approval be disclosed in a more detailed manner and, in certain cases, subject to a nonbinding shareholder vote. The law also requires all institutional investors subject to reporting under the Securities and Exchange Act of 1934 to report annually on how they voted on all say on pay and golden parachute votes.

The overall impact of these provisions will be to put many more compensation-related votes on corporate ballots and to make the voting records of many more institutions on these issues a matter of public record. Because many institutional investors will not have the time or resources to evaluate the executive compensation practices for their portfolio holdings of up to 10,000 publicly held companies, they will need to rely on outside services, especially proxy advisors, for analysis and voting recommendations on compensation matters.

A recent survey of 251 companies by Towers Watson, a global professional services firm, found that 59 percent of respondents believed that proxy advisors already have significant influence on executive pay decision-making processes at U.S. companies.[57] Some shareholder activists agree and predict that the advisory firm role will be strengthened. Edward Durkin, director of corporate affairs at the Carpenters Union, has noted it will be impossible for most institutional investors to vote on hundreds or thousands of compensation plans unless they rely on the advice of proxy advisory firms. "If you have an annual say on pay vote and you exercise your voting responsibility as we do ... it'd be overwhelming," said Durkin, whose union owns stakes in 3,500 companies.[58]

Proxy advisory firms clearly anticipate that say on pay will expand their influence. Patrick McGurn, Special Counsel to ISS, noted this point in 2010 while admonishing corporations to provide executive summaries for the Compensation Discussion and Analysis (CD&A) sections of their proxy statements. As filings became more voluminous, investors would not search through long

CD&As, McGurn said, so a failure to provide an executive summary means "you are giving more power to proxy advisors," who would read through the whole document.[59] Earlier, Peter Clapman, the former Senior Vice President and Chief Counsel for TIAA-CREF, expressed a similar sentiment, but questioned the wisdom of this approach:

> If applied to a universe of 10,000-plus public companies in the U.S. (in contrast to far fewer companies in the U.K.), most shareholders simply will not devote the necessary staff resources to vote intelligently as individual shareholders and will outsource the voting decision. The inevitable consequence would be to transfer considerable discretionary power over individual company compensation practices to the proxy advisory firms. I question that such an approach will serve the long-term best interests of shareholders.[60]

The overall effect of say on pay will be to increase the influence of proxy advisory firms as investors grapple with more than 16,000 additional proxy votes in 2011, many of which will require an understanding of each company's pay philosophy and arrangements.

Elimination of Broker Discretionary Voting in Uncontested Elections and on Key Compensation Issues. In the current U.S. proxy system, broker-dealers have a significant influence on proxy voting outcomes in their role as intermediaries between retail investors and corporate issuers. Public company shareholders can hold shares in one of two ways: directly, as record holders, or indirectly, in so-called "street name" accounts through their brokers. Under SEC and New York Stock Exchange (NYSE) rules, when investor shares are held with brokers in "street name," the broker is required to deliver proxy materials to the shareholder with a request for specific voting instructions on any matters to be voted on at the annual meeting.

Under NYSE Rule 452, if the broker does not receive voting instructions by the 10th day preceding a company's annual meeting, the broker is allowed to exercise discretionary voting authority to vote on all matters deemed "routine" by the NYSE. Brokers are not allowed to vote on matters deemed "non-routine" by the NYSE, such as shareholder proposals, without a specific instruction from the shareholder.

Until recently, votes to elect directors in uncontested elections were considered "routine" matters under NYSE Rule 452. On July 1, 2009, however, the SEC approved an amendment to that rule to eliminate broker discretionary voting in uncontested elections.[61]

The amendment applied to director elections on or after January 1, 2010, and affects all public companies, not just those listed on the NYSE. The change was made by the NYSE following the recommendation of its Proxy Working Group. It was based heavily on arguments that voting in director elections is one of the most important ways that shareholders can influence corporate governance and that this right should be limited to those who hold an economic interest in the company.

The rule change is potentially quite significant because broker discretionary votes have typically been cast in favor of management and can comprise up to 20 percent of proxy votes at some companies. With a dramatic increase in elections where directors receive significant numbers of "withheld" votes in recent years, the elimination of broker discretionary voting could result in more directors failing to achieve majority support from shareholders.[62]

The NYSE's amendment to Rule 452 has also influenced legislation addressing the financial crisis. The 2010 Dodd-Frank Act directs the SEC to issue new regulations prohibiting broker discretionary voting of client securities held in street name on executive compensation issues, including say on pay and golden parachute votes as well as "any other significant matter" as determined by the Commission.[63] The legislation effectively extends the rationale of prohibiting uninstructed broker votes in director elections to compensation issues – with the inference that say on pay votes are important ways shareholders can influence executive compensation. However, many believe that the effect will be to disenfranchise many retail shareholders, thus further strengthening the dominance of institutional investors in the proxy voting process.

In sum, the elimination of broker discretionary voting in director elections and on important compensation matters will erode the impact of retail investors in proxy voting and enhance the influence of institutional investors. It will also further expand the power of the proxy advisory services over governance matters.

Proxy Access for the Nomination of Directors. On August 25, 2010, the SEC voted by a 3 to 2 margin to enact a rule granting "proxy access" to certain shareholders for the purpose of nominating directors on a company's proxy ballot.[64] The rule will allow shareholders meeting certain ownership requirements (three percent of a company's shares held continuously for a minimum of three years) to nominate directors comprising up to 25 percent of the board on the company's proxy card. The rule applies to all U.S. corporations, but it exempts small companies from

compliance with the rule for a period of three years.[65] The SEC also amended Rule 14a-8 to allow shareholder proposals seeking bylaw amendments relating to proxy access.[66] The rule allows shareholders to use such proposals to alter proxy access restrictions at specific companies to make them less stringent – but not more stringent – than the requirements set in the SEC's rule.

The final proxy access rule was adopted after hundreds of public comments were filed on the SEC's proposed rule, which was released in May 2009. A vote on a final rule was delayed until after final Congressional passage of financial reform legislation, with many observers speculating that the delay was due to concerns by the SEC about possible court challenges to its statutory authority to enact proxy access. The Dodd-Frank Act sought to address such concerns by explicitly authorizing the SEC to adopt rules governing proxy access. However, the validity of the rule is being challenged in federal court,[67] and the SEC has suspended its implementation pending the court's ruling. If the rule is ultimately upheld, the long-term impact will be to increase the number of contested elections on which institutional investors need to vote. As Judy Schub, former Managing Director of the Committee on Investment of Employee Benefit Assets (CIEBA), an association of more than 100 of the largest U.S. private sector pension plans, noted in a comment letter to the SEC on proxy access:

> CIEBA members are also concerned that the proposal, as drafted, will enhance the authority of the proxy advisory services. Currently, only three organizations control the business, with one of the three enjoying the dominant market position. There is little oversight or regulation of these proxy advisory services by any public entity nor is there any meaningful disclosure about the significant role they play in proxy voting decisions. They exercise significant power over corporate governance since the vast majority of institutional investors use their guidance on proxy voting. These new proxy access standards will give them even greater power over the election of boards of directors.[68]

In sum, the proxy advisory industry has greatly expanded its power and influence over corporate governance in the U.S. in recent decades. This expansion is the result of a combination of underlying economic factors – which have driven institutions to look for third-party help in dealing with ever increasing workloads related to proxy voting – coupled with regulatory developments that have both directly and indirectly encouraged the use of proxy advisors.

IV. The Proxy Advisory Firms and Their Services

Proxy advisors play a significant and growing role in influencing shareholder votes in the U.S. and global proxy voting system. The industry in the U.S. is highly concentrated, with a handful of firms controlling virtually the entire market for proxy research and advice and one entity – Institutional Shareholder Services – holding a dominant market position. In theory, proxy advisors are subject to significant regulatory standards that govern their conduct. In practice, however, there have been few, if any, constraints on proxy advisors, and there is significant concern by companies, investors and others that conflicts of interests influence their recommendations. This section will briefly describe the history and services provided by each of the proxy advisory firms, which puts into context the conflicts and operations concerns discussed later in this paper.

A. Institutional Shareholder Services

Institutional Shareholder Services (ISS), the dominant firm in the proxy advisory business, is currently a division of MSCI Inc., a leading provider of investment decision support tools and indexes to investors worldwide. ISS has undergone two changes in ownership in recent years: in January 2007, it was purchased by RiskMetrics Group Inc. for $542.6 million in cash and stock.[69] RiskMetrics is a leading provider of risk assessment and wealth management products that was spun off from J.P Morgan Chase & Co. in 1998. Then, after RiskMetrics went public in January 2008, RiskMetrics was acquired by MSCI on June 1, 2010, in a cash and stock transaction valued at $1,572.4 million.[70]

ISS is a Delaware corporation that is also a registered investment adviser regulated by the SEC. ISS is headquartered in Rockville, Maryland, and maintains offices in New York City, Chicago, Illinois, Norman, Oklahoma, London and Makati City, Philippines. It also has affiliates in Europe, Canada, Japan and Australia and has between 500 and 1,000 employees worldwide.[71]

History and Ownership: ISS was founded in 1985 by Robert A.G. Monks, a former administrator of the Office of Pension and Welfare Benefits Programs at the U.S. Department of Labor under President Reagan, who also appointed him as one of the founding trustees of the Federal Employees' Retirement System. Monks served as President of ISS from 1985 to 1990.

ISS has a long history of acting as a consolidator within the proxy industry as well as being bought and sold itself at ever increasing valuations. A list of the major acquisitions by, and purchases of, ISS is shown in Table 1 below. As of 2010, it had made at least eight acquisitions of other firms in the proxy advisory, governance and corporate responsibility sectors since 1985.

TABLE 1: Timeline of Institutional Shareholder Services (ISS): The Proxy Industry Consolidator

1985 – ISS founded by Robert A.G. Monks
June 1995 – ISS is acquired by the CDA unit of Thomson Financial Services, a unit of The Thomson Corp.
1997 – ISS acquires Proxy Voter Services, a proxy advisor to union funds
August 2001 – Proxy Monitor purchases ISS from Thomson Financial, with major financial backing from Warburg Pincus, Hermes Investment Management Ltd. and others for a reported sale price of $45 million. The merged company retains the ISS name and installs Robert C.S. Monks, son of Robert A.G. Monks, as Chairman
May 2005 – ISS completes acquisition of the corporate governance unit of Brussels-based Deminor International for $1.0 million
June 2005 – ISS completes acquisition of Proxy Australia Pty Ltd., Australia's leading governance research firm for $0.7 million
August 2005 – ISS completes acquisition of IRRC, a leading U.S. proxy research firm for $14.3 million
January 2007 – RiskMetrics completes acquisition of ISS for $542.6 million in cash and stock
July 2007 – RiskMetrics announces definitive agreement to acquire the Center for Financial Research and Analysis (CFRA), a leading financial forensic analysis firm, for $61.4 million
January 2008 – RiskMetrics prices IPO
February 2009 – RiskMetrics announces acquisition of Innovest Strategic Value Advisers, an environmental investing research firm for $14.3 million in cash
November 2009 – RiskMetrics completes acquisition of KLD Research and Analytics, a leading ES&G research firm for $9.9 million in cash
June 2010 – MSCI completes acquisition of RiskMetrics Group for nearly $1.6 billion

ISS was sold by its founders in June 1995 to a unit of Thomson Financial Services (currently Thomson Reuters), a Canadian publishing and information services conglomerate. Six years later, in August 2001, Thomson sold ISS for a reported $45 million to a group of financial investors, including the U.S. private equity firm Warburg Pincus, Hermes Investment Management Ltd. (a unit of the Hermes Group, a wholly-owned subsidiary of the BT Pension Scheme – the pension fund for the U.K.'s largest telecommunications firm). Together, Warburg Pincus and Hermes owned approximately 57 percent of the equity in ISS.[72] The sale included a reverse merger into a smaller proxy advisory firm called Proxy Monitor, with the merged firm retaining the ISS name. Interestingly, Robert C.S. Monks, the son of ISS's founder, was named chairman of the merged company, a post he held until the company's sale to RiskMetrics in 2007.

Several years after the merger with Proxy Monitor, in 2005, ISS embarked on an acquisition strategy, purchasing in rapid succession three proxy research and governance businesses – the commercial business assets of the Investor Responsibility Research Center (IRRC), the governance business of Belgium-based Deminor International and Proxy Australia Pty Ltd. The three purchases augmented ISS's already dominant worldwide market position at that time. After being purchased by the RiskMetrics Group, Inc. in 2007, several additional firms were integrated into ISS – notably CFRA, Innovest Strategic Value Advisers and KLD Research & Analytics. CFRA was a leading forensic accounting analysis firm and Innovest and KLD each had a long history of providing environmental, social and governance research to institutional investors.

A comment by MSCI CEO Henry Fernandez at the time of the closing of MSCI's purchase of RiskMetrics has led to speculation that the ISS segment of RiskMetrics could be sold again. Fernandez called the ISS part of RiskMetrics "non-core" in an investor conference call, but said the firm planned to retain it because of its cash generation.[73] Ethan Berman, the CEO of ISS since 1998, later reinforced the possibility of an ISS sale, saying that selling ISS "is not the intent but is a possibility."[74] As of August 2010, persistent market rumors were circulating that ISS was again being shopped, with private equity firms showing interest.

Current Services and Business. According to the 2009 Form 10-K filing for RiskMetrics Group, ISS provided services to approximately 2,970 clients as of year-end 2009 through a network of 20 offices in 12 countries.[75] ISS divides its services into two general categories: Governance Services and Financial Research

and Analysis Services. Within the Governance Services segment, the company further categorizes its services into three business areas: Proxy Research and Voting, Global Proxy Distribution Services and Securities Class Action Services.

Regarding proxy research and voting, the company notes that it is the largest firm in the industry and says that it "offers a fully-integrated, end-to-end proxy voting service, including policy creation, comprehensive research, vote recommendations, reliable vote execution and reporting and analytical tools."[76] It says it issued proxy research and recommendations for more than 37,000 shareholder meetings in 108 countries and voted, on behalf of its clients, more than 7.6 million ballots representing over 1.3 trillion shares in 2009.

The Global Proxy Distribution Services business offers a global proxy distribution solution to custodian banks for non-U.S. securities through a single platform. The Securities Class Action Services business delivers class action monitoring and claims filing services to institutional investors who have potential recovery rights in class action lawsuits.

In its Financial Research and Analysis segment, ISS has four principal business lines: CFRA forensic accounting research, Environmental, Social & Governance Services (ES&G), M&A Edge and Compensation Advisory Services. The CFRA forensic accounting research provides risk analysis reports on earnings and cash flow quality, legal and regulatory risk and general business health for more than 10,000 companies worldwide. The ES&G Services include screening and modeling tools to allow institutional investors to apply social guidelines or restrictions to portfolios as well as company-specific reports, profiles and analytics. The M&A Edge service provides in-depth analysis on proposed merger and acquisition transactions and proxy contests.

The Compensation Advisory Services provide products and services designed to allow compensation professionals and corporate board members to model, optimize and benchmark executive compensation plans. This segment offers both corporate advisory services that include access to compensation analysts or a web-based compensation modeling tool that measures the cost of equity incentive plans using ISS's proprietary binomial option pricing model. This sale of consulting services to corporations at the same time it is advising investors how to vote on management and shareholder proposals on the same issues has been a highly criticized and controversial aspect of ISS's business model.

Significant Share of Goodwill Written Off in Recent Years. ISS's revenues and profitability for 2009 are disclosed in RiskMetrics' 2009 Form 10-K filing, which shows total 2009 ISS revenues of $144.7 million, up 2.0 percent from $141.8 million in 2008.[77] On a product basis, Governance Services (mainly proxy research and voting) accounted for $92.4 million in revenues, while Financial Research and Analysis accounted for $52.3 million. ISS segment income from operations in 2009 was $10.9 million, up from a loss of $148.7 million in 2008, when results were negatively impacted by a $154.2 million non-cash write-down to ISS goodwill "primarily as a result of the negative equity market conditions which caused a material decline in industry market multiples in the second half of 2008" and a $5.9 million write-down related to an ISS product trademark.[78]

Consulting Services May Support Advisory Operations. ISS has also disclosed on its website that approximately 17 percent of its total revenues are generated from its ICS subsidiary, which provides consulting services to corporations.[79] This consulting revenue is highly significant because it is widely believed to be highly profitable to ISS (because much of it results from charging corporations for use of elements of the ISS compensation model). In fact, some observers believe that without this highly profitable revenue source, ISS's operations would be unprofitable or, at best, only marginally profitable. This may account for the firm's reluctance to spin-off or otherwise separate this business – in spite of the tremendous amount of criticism it has engendered for creating conflicts of interest, as discussed in depth later in this paper.

Offshoring. In recent years, ISS has made a major push to reduce its cost structure by locating much of its data collection and research activities outside the United States, particularly to the Philippines. The 2009 RiskMetrics Form 10-K acknowledges the importance of this, stating:

> ISS' clients outsource proxy voting and vote reporting to ISS. We have had success in meeting client requirements while also increasing our transactional volume through increased automation and by leveraging our operations center in Manila, Philippines. This operations center reduces the operational cost per transaction and has been a key component of our success.[80]

In March 2010, ISS introduced a new scoring system designed to measure corporate governance practices known as Governance Risk Indicators (or GRId). The new indicator is based on an evaluation of a company's compliance with what ISS has determined are "best practices" in four key governance areas:

audit, board structure, shareholder rights and compensation. Scores for U.S. companies are based on answers to 63 questions in these areas. The GRId corporate governance indicator replaced a former ISS indicator known as the Corporate Governance Quotient (CGQ), which ISS had widely promoted for years as a useful indicator for assessing corporate governance. CGQ scores were discredited by some academic studies, however, which found that they did not predict future financial performance or governance-related outcomes or provide useful information to shareholders.[81]

B. Glass, Lewis & Co.

Glass, Lewis & Co. was founded in January 2003 and is the second largest firm in the proxy advisory industry. It is currently an indirect wholly-owned subsidiary of The Ontario Teachers' Pension Plan Board (OTPP), one of the largest pension systems in Canada, which creates the potential for considerable conflicts as well. The firm has more than 100 employees and is headquartered in San Francisco, California, with offices in New York, Sydney, Paris and Tokyo. Glass Lewis is organized as a limited liability corporation, incorporated in Delaware, and is not registered as an investment adviser with the SEC.[82]

History and Ownership. Gregory P. Taxin, Lawrence M. Howell, and Kevin J. Cameron, co-founded Glass, Lewis & Co. in 2003.[83] Taxin had been an investment banker at Bank of America Securities and Epoch Partners, as well as a Vice President in the investment banking division at Goldman, Sachs & Co. Howell also had a background as an investment banker at Goldman Sachs and Morgan Stanley & Co. and, since 1996, had been the managing partner at Howell Capital, an investment consulting and advisory firm. Cameron was a lawyer who had served as the general counsel of Moxi Digital, a technology venture, and Northpoint Communications, a telecommunications firm. Taxin became Glass Lewis' CEO, Howell served as chairman and Cameron became president.

According to Rustic Canyon Partners, a venture capital firm that was an early investor in the firm, Glass Lewis was initially capitalized by its founders and a group of research analysts, accountants, publishers and bankers.[84]

The firm grew relatively quickly after its initial launch due in part to the fact that while it did not initially have an electronic voting platform to provide comprehensive voting services, it negotiated an arrangement with IRRC in late 2003 to make its proxy analyses and recommendations available to IRRC's voting

clients. The deal provided Glass Lewis with a fast and efficient way to reach IRRC's hundreds of voting clients. (IRRC was interested because its research reports did not offer voting recommendations – which were increasingly demanded by many institutional investors.) By the time IRRC was purchased by ISS in 2005, many of its clients had already been exposed to Glass Lewis' research and kept their services with that firm (which had by then developed its own voting platform).

The firm also diversified its offerings to include forensic accounting reports and alerts designed to aid investors in spotting companies with suspicious accounting practices – a timely service in the wake of accounting scandals at companies such as Enron and WorldCom. It also developed, in conjunction with several business professors, a governance-enhanced S&P 500 Index, dubbed the board accountability index, which was designed to weight companies in the index based on their governance characteristics.

In September 2005, Glass Lewis raised approximately $4 million through the sale of preferred stock in the firm to accredited investors. An SEC filing for the offering at that time listed – in addition to the founders and Rustic Canyon – three additional owners: Lynn Turner, Shamrock Estate Holdings LLC (Burbank, Cal.) and Ojibawa Investment Partners (Chicago, Ill.)[85] Turner was a former chief accountant at the SEC who was recruited in 2003 to be Glass Lewis' managing director of research. By 2006, Glass Lewis had about 200 clients and was rapidly expanding its research coverage to overseas markets.

In August 2006, Glass Lewis announced that Xinhua Finance Ltd., a leading financial information and media provider in China, had purchased a 19.9 percent stake in the company. Then, in December, it announced that Xinhua would exercise an option to purchase the remaining equity in the firm, with the deal expected to close in early 2007. The total purchase price for the Glass Lewis, paid partly in cash, but mostly in Xinhua Finance stock, was approximately $45 million. Xinhua Finance is headquartered in Shanghai, China, has its stock listed on the Mothers Board of the Tokyo Stock Exchange and is incorporated as a holding company in the Cayman Islands.[86] In announcing the transaction, Glass Lewis said it planned to expand its coverage to Chinese and other emerging market companies, but would continue to operate as a separate company with its existing management, client service and research teams.[87]

Within months after closing its deal with Xinhua Finance though, there were ominous signs of trouble at the parent company. In March 2007, Xinhua Media, the unit of Xinhua Finance of which Glass Lewis was part, raised $300 million through an initial public stock offering in the U.S. Media reports soon emerged, however, that the IPO prospectus had failed to disclose that Shelly Singhal, the CFO of Xinhua Finance and Xinhua Media, had performed investment banking services for two companies that had been exposed as frauds and that he was being sued in California civil court for racketeering.

In April, it was announced that CEO Greg Taxin would leave Glass Lewis for a new position focused on business development at Xinhua Finance Ltd. and would be replaced by Katherine Rabin. Then, in May, two of Glass Lewis' prominent senior executives quit. First, Jonathan Weil, a managing director who was a former Wall Street Journal reporter, announced he was leaving, stating publicly in his resignation letter that he was "uncomfortable and deeply disturbed by the conduct, background and activities of our new parent company Xinhua Finance Ltd., its senior management, and its directors. To protect my reputation, I no longer can be associated with Glass Lewis or Xinhua Finance."[88] The following week, on May 21, 2007, Lynn Turner, the firm's managing director for research, also announced he would resign from the firm, citing "recent changes in ownership."[89]

The disclosures left Glass, Lewis & Co., which had built its reputation largely on its ability to identify corporate accounting problems, scrambling to retain its clients, many of whom were also reported to be uneasy over the prospect of purchasing proxy and forensic accounting research from a firm now owned by an information and media conglomerate with close ties to the Chinese government. By October 2007, it was announced that Xinhua Finance would sell Glass Lewis to the Ontario Teachers' Pension Plan for $46 million. OTPP was a client of Glass Lewis and had helped to create a Canadian investor group dedicated to improving corporate governance.[90]

Current Services and Business. According to Glass Lewis's website, the firm provides research and analysis on more than 16,000 companies around the world. The company lists six services it provides: Risk Alerts, Risk Monitor, Proxy Research and Voting Solutions, Trend Reports, Share Recall Service and Class Action Settlement Solutions. The firm is not registered as an investment adviser and hence is not directly regulated by the SEC.

Risk Alerts and Risk Monitor are web-based applications that enable investors to monitor public companies for signs of unusual risk or developments that could harm shareholders and provide rankings of a company's relative risk based on more than 30 data patterns that Glass Lewis has identified as predictive of risk to shareholder value. The services provide a review of earnings quality and presents relative risk scores for more than 4,200 North American securities.

Glass Lewis says its proxy research service, called Proxy Paper, covers more than 16,000 public companies in 70 countries. The company says Proxy Paper is available "as a standalone service or as part of a turnkey solution that encompasses all aspects of the proxy voting process - including reconciliation, vote execution, record keeping and reporting, Form NPX and Web hosting."[91] The company says its voting platform and system, called Viewpoint, is designed to provide accurate, transparent and auditable voting.

Glass Lewis's Trend Reports are comprehensive studies on accounting issues and regulatory developments that disproportionately affect certain industries of companies. Its Share Recall Service is designed to allow institutions that lend shares to maximize these programs by selectively recalling shares on loan, for certain important proxies, based on a proprietary algorithm that analyzes and scores various factors such as accounting restatements, excessive executive compensation and prior year voting results. Its Class Action Settlement Solutions handles all aspects of class action claims, including identifying eligible claims and amounts, filing claims, following up on rejections and auditing amounts recovered against claim amounts.

C. Proxy Governance, Inc.

Proxy Governance Inc. (PGI) was founded in June 2004 by Steven Wallman, who served as an SEC Commissioner from 1994 to 1997 under President Clinton. Until December 2010, the firm was a wholly-owned subsidiary of FOLIOfn, Inc., a financial services and technology firm based in McLean, Virginia, where Wallman serves as CEO. Proxy Governance was incorporated in Virginia and the firm was registered as an investment adviser with the SEC. On December 20, 2010, Glass Lewis announced that it had "entered into an agreement with Proxy Governance, Inc. ('PGI') to provide proxy voting and advisory services to PGI's clients."[92] This announcement went relatively unnoticed and neither Glass Lewis's, nor Proxy Governance's websites have yet to reflect this corporate change. In order to provide a complete understanding of the proxy advisory industry, we have included the

history and services provided by Proxy Governance that will now be assumed by Glass Lewis.

History and Ownership. According to Proxy Governance's website, a proxy advisory and voting service was part of the original business plan for FOLIOfn, which was founded in 1998. That firm started to build a proxy service in 1999 and 2000, but those plans were put on hold after the steep market downturn following the Sept. 11, 2001, terrorist attacks. The PGI website says FOLIOfn reinitiated work on the service in 2003, following the development of a favorable regulatory environment that would expand the market for proxy advisory services. The firm completed work on its initial product offering in late 2004, and launched its advisory service for the 2005 proxy season. The firm's launch was partially financed through a one-year bulk subscription agreement with The Business Roundtable, an association of CEOs of leading U.S. corporations, on behalf of its member companies.[93]

Proxy Governance's parent firm, FOLIOfn, Inc., also owns a registered broker-dealer, FOLIOfn Investments, Inc., which offers an integrated brokerage and technology platform that allows clients to purchase and trade customizable portfolios of securities in a single transaction. The owners of the parent firm are listed in Proxy Governance's 2009 Form ADV as Steven M. H. Wallman, MVC Capital, Inc. (a business name for the MEVC Draper Fisher Jurvetson Fund 1, Inc.) and FISCOP LLC.[94] FISCOP LLC is, in turn, majority-owned by Broderick Management LLC, which is owned by billionaire investor, Gordon P. Getty.[95]

Services and Business. Proxy Governance offered proxy research, vote recommendations and voting services. On its website, the company says that it has developed "a better approach to proxy analysis: providing advice with the goal of truly building long-term shareholder value."[96] Rather than looking at issues in isolation, the firm says it "evaluates proxy issues and makes voting recommendations on an issue-by-company basis, considering a company's performance record, business environment, management strength, corporate governance and other factors."[97] The firm says it offers "a comprehensive range of flexible, Web-based proxy advisory, voting and reporting services."[98] It says its coverage universe is based on the securities held in client portfolios and that coverage for some non-U.S. markets is provided through partnerships with other proxy advisory firms. In particular, Proxy Governance maintained a relationship for coverage of many European and Asian securities with Manifest Information Services, Ltd., a U.K.-based proxy research and voting firm.

According to its 2009 Form ADV, Proxy Governance had between 11 and 50 employees and less than 100 clients.[99] Until December 20, 2010, Michael Ryan served as the President and COO of Proxy Governance, a position he had held since June 2008. It is unclear whether Ryan will join Glass Lewis following its assumption of Proxy Governance's proxy voting and advisory services.

In early 2010, Proxy Governance began to explore a possible change in its business model. In a concept summary it made available to some industry participants in June 2010, the firm said it was considering a "radical change" to restructure itself into a non-profit entity called the Proxy Governance Institute.[100] The concept summary stated that the "current for-profit business model is a barrier to serving the full range of investors, including individual investors" and that a superior approach would be "to redeploy PG's services in a new business model supported by user fees and supplemented by third-party sponsorship."[101]

The summary noted that investors and issuers spent hundreds of millions of dollars annually preparing and distributing proxies and soliciting votes, but said that the business opportunities for providing access to corporate governance and voting services were "substantially narrower than the wide-ranging need for these services. As a result, many investors – especially individual investors and small and medium-size institutions – are unserved or underserved," the summary said.[102] The proposed new entity would serve institutional and individual investors, not provide consulting services to issuers and "offer basic corporate governance and proxy voting services for free and reduced cost."[103] The new institute would have a transparent proxy voting policy that was subject to public comment, would provide "due process" to enable shareholder proponents and issuers to appeal recommendations, and would have a Board of Governors comprised of investors, issuers and directors.[104]

D. Egan-Jones Proxy Services

Egan-Jones Proxy Services was incorporated in 2002 to provide proxy advisory services. The firm is not registered as an investment advisor with the SEC although its parent firm is registered with the SEC as a Nationally Recognized Statistical Rating Organization (NRSRO).

History and Ownership. Egan-Jones Proxy Services is a division of Egan-Jones Ratings Company, which was founded in 1994. The firm is based in Haverford, Pennsylvania. The founding principals of the firm are Sean J. Egan and Bruce Jones. Egan is a former banker who worked at Chemical Bank (now part of J.P. Morgan Chase & Co.) and then with KPMG as a consultant to banks before starting a research firm called Red Flag Research in 1992. Egan hired Jones, a former Moody's analyst, and the firm was renamed Egan-Jones and issued its first ratings in 1995.[105]

Egan-Jones Ratings differs from the largest credit rating agencies, including Standard & Poor's Corp. and Moody's Investors Service, in that it is not paid by issuers to rate securities, but solely by institutional investors. In 2008, the firm was granted status as a NRSRO by the SEC.[106] Egan-Jones Ratings Services has approximately 400 institutional investor clients, but it is not known how many of these utilize the firm's proxy service.[107]

Current Services and Business. Egan-Jones says on its website that it provides proxy research, recommendations and voting services for both U.S. and foreign proxy proposals on an annual subscription basis, with prices based on the number of securities held. It says it offers two sets of voting guidelines so clients can choose whether to vote in accordance with Taft-Hartley concerns or whether overall shareholder value considerations should take precedence. The company says it provides the following integrated proxy services: set-up, notification of meetings, research and recommendations, voting guidelines and client override flexibility, execution of votes, and vote disclosure and guidelines.[108]

Egan-Jones indicates that unlike some of its competitors, it is "completely independent" and does not receive any compensation for proxy consultation services from corporate managers or board members and is therefore better able to represent shareholders and Taft-Hartley clients' interests.[109] The company says that it has a "deep bench of very experienced credit risk analysts" from its credit ratings business and, therefore, when proxy votes involve corporate finance issues, its experts can "scrutinize these numbers with a trained eye instead of just accepting management's expectations."[110] The company also says it is revolutionizing the proxy industry with low fees and transparent pricing, including a flat fee of $12.50 per company per year for all clients.

E. Other Proxy Advisors

Although the proxy advisor market is dominated by ISS and Glass Lewis, there are niche players that are able to carve out small markets for themselves. Examples include Marco Consulting Group, which has concentrated primarily on Taft-Hartley funds, and the Sustainable Investments Institute, which concentrates on research for academic institutions endowment funds.

Marco Consulting Group. Marco Consulting Group, Inc. (MCG) is an Illinois corporation, that provides consulting and investment advice to jointly-trusteed plan sponsors, primarily Taft-Hartley pension plans. The firm, which has offices in Chicago and Boston, was founded by Jack M. Marco in 1988. Marco, who continues to serve as chairman of the MCG, owns more than 50 percent of its stock, according to the firm's most recent SEC Form ADV.[111] MCG has been registered as an investment adviser with the SEC since 1989. On its website, MCG says it is the largest consultant to jointly-trusteed benefit plans in the U.S. with more than 350 clients.

Marco Consulting says it offers a proxy advisory service to its Taft-Hartley clients that "reviews each proxy issue with final decisions based on the merits of each case and with the best interest of the plan's participants and beneficiaries in mind."[112] The firm's website lists six employees who work in its proxy voting division, which is headed by Greg Kinczewski, VP and General Counsel of Marco Consulting Group. Proxy advisory services comprise a small fraction of Marco Consulting Group's revenues with approximately 4 percent of the firm's total revenues attributable to proxy voting services clients.[113]

Sustainable Investments Institute. The Sustainable Investments Institute (Si2) is a non-profit proxy research firm founded in 2009 to provide educational proxy research to subscribers. The firm is based in Washington, D.C. Si2 issues briefing papers and in-depth company-specific reports and has an on-line journal and blog. Its analyses, which focus exclusively on social and environmental issues, do not make voting recommendations.[114] It issued its first reports for the 2010 proxy season to an initial group of subscribers comprised primarily of college and university endowments. Heidi Welsh and Peter DeSimone co-founded Si2 with Welsh serving as Executive Director of the firm. Both Welsh and DeSimone have previous experience in the proxy advisory industry with the IRRC and ISS.

F. Conclusion

The proxy advisory firm industry is concentrated primarily in two firms – ISS and Glass Lewis – with ISS dominating the market. The industry has grown through demand due to the increase in proxy votes, acquisition and development of new product ideas. However, underlying the growth, especially of ISS, is the existence of serious conflicts of interest that call into question the firm's voting recommendations. Both ISS and Glass Lewis have been identified by corporate issuers as including material inaccuracies in some of their reports. Yet, despite these serious issues, other entrants and participants in the market that do not have such issues, at least to the same extent, have only been able to play a minor role.

V. Conflicts of Interest in the Proxy Advisory Industry

One of the most common and long-standing concerns voiced about firms in the proxy advisory industry is that their business models suffer from conflicts of interest. Almost from the time the industry was created, proxy advisory firms have been criticized for providing product offerings or ownership structures that could compromise the analyses they provide. In 1994, for instance, after ISS announced that it would begin consulting with corporations on how they might respond to shareholder concerns, Graef Crystal, a prominent compensation consultant, put the conflict issue this way:

> They've got a severe conflict when they work both sides of the street. It's like the Middle Ages when the Pope was selling indulgences. ISS is selling advice to corporations on how to avoid getting on their list of bad companies. There's a veiled sense of intimidation.[115]

While concerns about conflicts of interest at proxy advisors date back decades, these concerns have never been resolved and continue to attract high-profile attention. Evidence of the continuing high level of concern over this issue includes the fact that the U.S. Government Accountability Office (GAO) has twice been asked by Congress to study the issue – most recently in 2007 – and the issue plays a central role in a "concept release" on the U.S. proxy system issued by the U.S. Securities and Exchange Commission in July 2010.[116]

Concerns about conflicts of interest in the industry fall into four general categories:

1. Potential conflicts that arise when proxy advisors provide services to both institutional investors and corporate issuers on the same subjects;
2. Potential conflicts related to proxy advisors providing recommendations on shareholder initiatives backed by their owners or institutional investor who are clients;
3. Potential conflicts when the owners, executives or staff of proxy advisory firms have ownership interests in, or serve on the boards of, public companies that have proposals on which the proxy advisors are making voting recommendations; and
4. Potential conflicts when proxy advisory firms are owned by firms that provide other financial services to various types of clients.

The Center believes that some of these conflicts need to be eliminated and others need to beat least fully disclosed, so that the information presented in proxy firm analyses can be placed in the appropriate context. The following sections will describe the extent to which each of these potential conflicts pertain to the major proxy advisory firms and how those firms describe these conflicts and the measures they have taken to address them. A chart summarizing these conflicts is shown below in Table 2.

TABLE 2: Types of Potential Conflicts of Interest at Major Proxy Advisory Firms

	ISS	Glass Lewis	PGI*	Egan-Jones	Marco Consulting
Specialized Consulting Services to Corporations on Proxy-related Issues	X				
Makes Recommendations on Proposals Sponsored by Institutional Clients	X	X	X	X	X
Owners, Directors or Officers Serve on Public Company Boards	X	X			
Proxy Advisor or Corporate Parent Firm Provides Other Services to Clients	X	X	X	X	X

* Proxy Governance, Inc. ceased operation on December 31, 2010 and transferred its clients to Glass Lewis

A. Institutional Shareholder Services Inc. (ISS)

ISS – as the largest proxy advisory firm, with the most lines of business, and owned by a major public company – is potentially subject to all of the categories of conflicts described above. In previous analyses of conflicts of interest among proxy advisors, the most commonly cited conflict involves a central aspect of ISS's business model, which involves providing proxy advisory services to institutional investors and, at the same time, providing consulting services to corporate clients on how to achieve a better governance rating or favorable recommendation on an issue covered in the analysis provided to institutions. The 2007 GAO study of the proxy advisory industry described this conflict, which is a result of the influence ISS has in the market, as follows:

> Because ISS provides services to both institutional investors and corporate clients, there are various situations that can potentially lead to conflicts. For example, some industry professionals stated that ISS could help a corporate client

> design an executive compensation proposal [company stock plan] to be voted on by shareholders and subsequently make a recommendation to investor clients to vote for this proposal. Some industry professionals also contend that corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings. One industry professional further believes that, even if corporations do not feel obligated to subscribe to ISS's consulting services, they still could feel pressured to adopt a particular governance practice simply to meet ISS's standards even though the corporations may not see the value of doing so.[117]

Similarly, a report by the Millstein Center On Corporate Governance, stated that the many companies believe that "signing up for [ISS] consulting provides an advantage in how the firm assesses their governance" despite ISS disclaimers to the contrary.[118] Corporate governance expert Ira Millstein has spoken harshly of this conflict inherent in the heart of the ISS business model:

> I am the last person to knock profit-making and the capitalist system. I like it. But ISS is in a special position, and I query whether profit-making fits well with credible private standard-setting. I don't think it does, and this is why. ISS has achieved an unusual role for a private profit-making entity. It provides structural "standards" for corporate governance, privately prepared by unidentified people, pursuant to unidentified processes, and asks us to take its word that it is all fair and balanced. I tried to dig behind the soothing assurances, but couldn't find enough detail to convince me that a devil didn't lie in the details of how this private standard-setting was put together. And then ISS provides company ratings, based on these privately-set standards, creating a tendency on the part of those that have received a poor rating to pay for a consultancy by the private standard-setter, on how to improve that rating. I see this as a vicious cycle.[119]

This particular conflict involving corporate consulting services is unique to ISS among the major proxy advisory firms. It has received significant attention over the years and has been widely criticized by both institutional investors and corporations, who are concerned that it drives what is considered "best practice," even if the so-called best practice is not in the interest of companies or their shareholders.

Concerns about this conflict have also resulted in some loss of investor clients, particularly among public pension funds. In 2004, for instance, Gary Findlay, the executive director of the Missouri State Employees' Retirement System, informed ISS that the pension fund was dropping ISS's services over concerns about its corporate consulting business. In a letter to ISS quoted in *The Washington Post*, Findlay wrote: "I see no merit in further wasting your time or mine regarding this issue. From this point forward, we will . . . engage an organization that at least has the appearance of undivided loyalty to . . . clients."[120] Similar concerns were voiced after decisions to drop ISS's proxy service by other major funds, including the Ohio Public Employees' Retirement System and the Colorado Public Employees' Retirement Association in 2005 and the Ontario Teachers' Pension Plan in 2006.[121]

ISS provides considerable disclosure on its website of the potential conflict created by its business model and the steps it has taken to mitigate this conflict. In the Due Diligence Compliance Package document posted on its website, ISS says it "is well aware of the potential conflicts of interest that may exist between ISS' proxy advisory service and ICS, and has therefore taken steps to prevent any potential conflicts from becoming actual conflicts."[122] "ICS" is an acronym for ISS Corporate Services, Inc., a wholly-owned subsidiary of ISS that provides corporate consulting services. ISS says that key elements of its policies and procedures "are designed to ensure the integrity of ISS' institutional proxy advisory and advisory research services."[123] Among these procedures, ISS says that it "maintains a firewall which separates the staffs that perform proxy analyses and advisory research from the members of ICS" and that this firewall includes "legal, physical and technological separations."[124] ISS also offers a "Representation and Warranty" regarding conflicts of interest to its subscribers and has a "Code of Ethics" that applies to all employees that includes a policy on conflicts of interest.[125]

In spite of the steps it has taken to manage conflicts, perceptions remain that ISS's business model is inherently conflicted, and ISS's own security filings acknowledge this problem. In a 2009 Form 10-K filing for its then-parent RiskMetrics Group Inc., it explicitly acknowledges the significant business risk posed by this conflict and the fact that its safeguards may not be adequate to manage these conflicts:

> [T]here may be a perceived conflict of interest between the services we provide to institutional clients and the services, including our Compensation Advisory Services, provided to certain corporate clients. For example, when we provide

> corporate governance services to a corporate client and at the same time provide proxy vote recommendations to institutional clients regarding that corporation's proxy items, there may be a perception that we may treat that corporation more favorably due to its use of our services.
>
> The safeguards that we have implemented may not be adequate to manage these apparent conflicts of interest, and clients or competitors may question the integrity of our services. In the event that we fail to adequately manage these perceived conflicts of interest, we could incur reputational damage, which could have a material adverse effect on our business, financial condition and operating results.[126]

The safeguards implemented by ISS as a firewall between the advisory and consulting businesses can only go so far. On its website, ISS states that when corporate clients meet with its proxy analysis staff, they should refrain from discussing whether the company has received consulting services from the other side of the company.[127]

Aside from the primary conflict associated with providing advisory services to both institutions and corporations, ISS appears to be subject to all three of the other types of potential conflicts of interest. The recent acquisition of its former parent company, RiskMetrics Group, by MSCI Inc. may, if anything, heighten these concerns because of the broader range of business interests found under the MSCI umbrella. According to Julie Gozan, director of corporate governance at Amalgamated Bank, a union-owned bank that provides investment and trust services to Taft-Hartley pension plans and engages in shareholder activism, notes that by going public, proxy firms become part of the market itself and can no longer solely represent the interests of long-term investors. "The community that relies on Glass Lewis and ISS needs to know this is unbiased advice that favors long-term investors and not the interests of corporate executives," Golan says.[128] "When these firms go public, there's real potential for a conflict of interest."[129]

B. Glass, Lewis & Co.

While Glass, Lewis & Co. does not provide consulting to companies and therefore does not have conflicts between proxy advisory and corporate consulting work, it is subject to conflicts between the company and its corporate owners.

After being formed as an independent company in 2003, Glass Lewis was acquired by Xinhua Finance, a Chinese company, in 2007. The level of client and staff concerns about Xinhua's governance, accounting and potential conflicts of interest were so severe that some of Glass Lewis's leadership resigned. These conflicts included the fact that Xinhua Finance owned other businesses that appeared to pose direct conflicts, including its Taylor Rafferty subsidiary, which provided proxy solicitation services to corporations.

Glass Lewis was sold to the Ontario Teachers' Pension Plan Board (OTPP) less than a year after its purchase by Xinhua and, while the conflicts there are not as severe, questions about the firm's ownership continue. OTPP is one of the largest institutional investors in Canada – administering pension funds for over 175,000 people – and is one of the most activist public pension funds on shareholder and corporate governance activism. On its website, OTPP says it promotes "good corporate governance standards and practices because we believe they result in better long-term performance."[130] It is a founding member of the Canadian Coalition for Good Governance, a membership organization of 41 Canadian institutional investors that says it "promotes good governance practices in Canadian public companies and the improvement of the regulatory environment to best align the interests of boards and management with those of their shareholders."[131] The pension system was also a founding educational partner in the Institute of Corporate Directors (ICR), which describes its mission as fostering "excellence in directors to strengthen the governance and performance of Canadian corporations."[132]

One concern about Glass Lewis' ownership by OTPP relates to the highly active role that OTPP plays in major corporate financings, restructurings and relationship investing – where an investor takes a major ownership stake in companies and partners with the management team in a long-term relationship. The pension plan's private equity arm, called Teachers' Private Capital, had $10 billion in invested capital at year-end 2009 and holds significant ownership stakes in dozens of companies. At the same time, the pension plan's public equities segment has a Relationship Investing Team that takes stakes ranging from 5 to 30 percent in

midcap to largecap companies. "As a significant shareholder, we take a hands-on approach with our investments," OTPP says. "We seek to develop relationships with the board and management of these companies, and to play a role in effecting strategies and changes that will improve the long-term value of our investment."[133] Some observers have questioned whether Glass Lewis will be able to make independent judgments on issues where OTPP has a major ownership stake. They also wonder whether OTPP's internal governance and voting policies will override those developed by Glass Lewis.

Glass Lewis provides a conflict of interest disclosure statement on its website, which highlights that the firm does not offer any corporate consulting services. "We are not in the business of advising public companies on their governance structures or conduct, and we refuse to use our position as trusted advisor to institutional investors to win consulting mandates with issuers," it states.[134] The firm also notes that it has formed an independent Research Advisory Council to insure that the firm's research "continues to meet the quality standards, objectivity and independence criteria set by Glass Lewis' outstanding research team leaders and excludes involvement by the company's owners in the making of Glass Lewis' proxy voting policies."[135] The Research Advisory Council was announced shortly after the departure of two senior Glass Lewis executives after the acquisition of the firm by Xinhua Finance.

Regarding the potential for conflicts of interest stemming from its ownership by OTPP, Glass, Lewis & Co. says:

> OTPP is not involved in the day-to-day management of Glass Lewis. Glass Lewis operates and will continue to operate as an independent company separate from OTPP. The proxy voting and related corporate governance policies of Glass Lewis are separate from OTPP. In instances where Glass Lewis provides coverage on a company in which OTPP holds a stake significant enough to have publicly announced its ownership in accordance with the local market's regulatory requirements or Glass Lewis becomes aware of OTPP's disclosure to the public of its ownership stake in such company, through OTPP's published annual report or any other publicly available information disclosed by OTPP, Glass Lewis will make full disclosure to its customers by adding a note to the relevant research report.[136]

In spite of the firm's insistence that it maintains its independence and will disclose any conflicts, concerns about the relationship between Glass Lewis and OTPP persist. As one commenter summarized the issue:

> It's hard to believe, however, that there will be no connection between the two entities. ... Earlier this year, [OTPP] lead a private equity group that bought Montreal-based communications giant BCE Inc., the biggest corporate takeover in Canadian history. So how is Glass Lewis going to evaluate the corporate governance practices of BCE? Indeed, how would it rate the practices of any company where Teachers' has a major investment? And what if Teachers' wants to take over another company? What will the Glass Lewis recommendation be to shareholders? No, it just doesn't wash. Either Teachers' sells Glass Lewis to a company that can legitimately argue that there is no potential for conflicts of interest, or boards and shareholders should discount and even ignore anything that Glass Lewis says. In today's climate of heightened sensitivity, if conflicts of interest are not good for chief executive officers or boards of directors, they're also not good for the people who police the markets.[137]

Concerns about conflicts of interest at Glass Lewis, within some segments of the market, are heightened by the fact that the firm has been less open in sharing draft reports with corporations and provides less transparency regarding its models than some other proxy advisory firms.

C. Proxy Governance, Inc.

As noted earlier, on December 20, 2010, it was announced that Proxy Governance, Inc. (PGI) will no longer provide proxy voting or advisory services beginning in 2011.[138] Glass Lewis has made an agreement with PGI to assume all of PGI's customer contracts. Despite the fact that PGI's operations recently ceased, there were potential conflicts of interest there as well. The discussion of these conflicts has been included in order to demonstrate how pervasive conflicts are in this industry.

Concerns about potential conflicts of interest at PGI have centered on the fact that an initial bulk subscription agreement from a business organization helped to finance the launch of the firm's proxy advisory service as well as the potential for conflicts involving its parent firm, FOLIOfn.

The concern over PGI's initial funding received prominent news attention in 2006, when a business columnist for *The New York Times* wrote an article mentioning that PGI's first subscriptions had been from members of The Business Roundtable (BRT), an organization representing the CEOs of large corporations. The article further suggested that a PGI recommendation endorsing a slate of directors at Pfizer might have

been influenced by the fact that Hank McKinnell, the CEO of Pfizer, was serving as the chairman of The Business Roundtable, and that William Steere, Jr., Chairman Emeritus of Pfizer and a director at that firm, also served on an advisory policy council at Proxy Governance.[139] The article also quoted from a 2004 memo written by McKinnell in his capacity as chairman of the BRT, urging its members to help Proxy Governance thrive in the marketplace by using its services.

The column in *The New York Times* appeared after the original bulk subscription agreement between Proxy Governance and the BRT had already expired. PGI publicly refuted the argument that its connections to the BRT or Pfizer had any impact on its Pfizer vote recommendation, but the article led to lingering questions from some institutional investors about PGI's ties to the business community and the degree of independence of its voting recommendations.

While no specific concerns about the ownership of PGI by FOLIOfn have surfaced in news reports or the academic literature, the relationship appeared to hold the potential for conflicts of interest. The GAO study on proxy advisors, for instance, notes that at proxy advisory firms where the parent company offers financial services to various types of clients, these relationships "may present situations in which the interests of different sets of clients diverge."[140] Some observers have also speculated that, because FOLIOfn and its broker-dealer subsidiary provide services that compete with the mutual fund industry, the relationship made it more difficult for PGI to attract mutual fund clients, which comprise a large part of the market demand for proxy advisory services.

At the time of the announcement that it was ceasing operations, Proxy Governance's public website did not contain a public disclosure statement regarding its policies toward conflicts of interest. The website did note the original bulk subscription agreement with the BRT as well as the firm's relationship with its parent company, FOLIOfn. As a registered investment adviser, Proxy Governance's Form ADV filing also provides some information about the firm's ownership and potential conflicts.[141] The company also had employee policies that addressed conflicts of interest.

D. Egan-Jones Proxy Services

Egan-Jones Proxy Services is subject to potential conflicts of interest related to its ownership by Egan-Jones Ratings Co., a credit ratings agency. Egan-Jones Ratings Co. has garnered considerable publicity for the fact that among accredited ratings agencies, it is virtually alone in adopting a policy of accepting compensation only from the users of its services, institutional investor subscribers, rather than from corporate issuers seeking ratings. Some observers note, however, that this stance does not necessarily eliminate all conflicts, because subscriber-supported credit ratings agencies may have incentives to issue ratings that cater to the wishes of their largest investor clients, including hedge funds that utilize short-selling strategies.[142] Egan-Jones Ratings Co. acknowledged that it has a material conflict of interest with subscribers in its application to become a nationally-recognized statistical rating organization (NRSRO), stating:

> Egan-Jones is paid by persons for subscriptions to receive or access the credit ratings of Egan-Jones and/or for services offered by Egan-Jones where such persons also may own investments or have entered into transactions that could be favorably or adversely impacted by a credit rating issued by Egan-Jones.[143]

The firm goes on to state, however, that it does not believe this conflict applies to its proxy services unit:

> In addition to providing credit rating services, Egan-Jones may provide proxy services to certain subscribers. Egan-Jones believes that providing these services to subscribers of its credit rating services does not present material conflicts of interest of the types contemplated in Exhibit 6, particularly since these subscribers are not also issuers that are being rated (or whose securities are being rated) by Egan-Jones.[144]

The website for Egan-Jones Proxy Services emphasizes that the firm is independent and does not offer corporate consulting services, but contains only a brief reference to conflicts of interest. Regarding conflicts, the website states that "[u]nlike many of our competitors, Egan-Jones does not receive any compensation for proxy consultation services from corporate managers or board members and is therefore better able to represent shareholders and Taft-Hartley clients' interests."[145] Similarly, the website for Egan-Jones Ratings Services says that the firm has no conflicts of interest because it receives no compensation from issuers to rate their securities.[146]

E. Union-Affiliated Proxy Advisors

Concerns about conflicts of interest at union-affiliated proxy advisors, such as Marco Consulting Group, stem from the fact that these firms' clients are Taft-Hartley pension funds that are also often active sponsors of shareholder proposals. This raises the concern that union-affiliated proxy advisors will always feel beholden to support proposals made by their Taft-Hartley clients. A study on voting integrity by the Millstein Center on Corporate Governance raises the issue as follows:

> Every year Marco's union clients sponsor a number of shareholder proposals. Most of these are in line with Marco's own proxy voting guidelines, but occasionally one is proposed that is contrary to their principles. Marco is then left in the potentially embarrassing position of recommending a vote against a proposal sponsored by one of its own clients. Marco seeks to limit the appearance of conflicts in such a situation by maintaining very comprehensive and specific proxy voting policies which make clear how the consultant would cast its vote under the circumstances. However, the possibility, though remote, that Marco could compromise its independence to satisfy clients causes concern to some.[147]

Regarding conflicts, Marco Consulting Group's public website states that "[s]ince MCG does not render consulting services to the corporate or investment management communities, it has no conflicts of interest."[148] The firm is also registered as an investment adviser and files a Form ADV statement that provides some information about ownership and potential conflicts.[149]

F. Parallels to Identified Conflicts at Credit Ratings Firms

Conflicts of interest at proxy advisory firms – while decades old – have recently become the subject of renewed scrutiny as part of an overall effort to increase transparency and restore confidence in the financial services sector of the economy. Some of this renewed interest is almost certainly due to the intense spotlight shined by the press, Congress and the SEC on the prominent role that conflicts of interest within the credit ratings industry played in fostering the credit and mortgage crisis that has engulfed the U.S. economy in recent years. Conflicts of interest at credit ratings agencies have been the focus of hearings, legislation, investigations and other actions from dozens of federal and international agencies and organizations. Among the U.S. government agencies and organizations that have taken actions on the issue are: Congress, the Financial Crisis Inquiry Commission,

the SEC, the U.S. Treasury Department, the Federal Reserve, the U.S. Department of Justice, the Federal Bureau of Investigation, the New York Insurance Department and the New York and California Offices of Attorneys General.

The results of this intense scrutiny, while still unfolding, include the establishment of almost an entirely new regulatory framework for credit ratings agencies in the Dodd-Frank Act. These regulatory changes are grounded in Congressional findings that the activities and performance of credit ratings firms, or NRSROs, are "matters of national public interest, as credit ratings agencies are central to capital formation, investor confidence, and the efficient performance of the United States economy."[150]

Recently, some observers have drawn parallels between the detrimental impacts to the economy that unfolded from widely acknowledged – but largely unaddressed – conflicts of interest at credit ratings firms and the current situation in the proxy advisory industry. The SEC highlighted this analogy in its July 2010 concept release requesting comments on the U.S. proxy system, where it stated that "in light of the similarity between the proxy advisory relationship and the 'subscriber-paid' model for credit ratings, we could consider whether additional regulations similar to those addressing conflicts of interest on the part of Nationally Recognized Statistical Rating Organizations ("NRSROs") would be useful responses to stated concerns about conflicts of interest on the part of proxy advisory firms."[151]

A 2009 study on the credit ratings agencies by the Congressional Research Service listed a number of perceived reasons for the industry's failings.[152] They included:

- business model bias;
- the existence of a quasi-regulatory license;
- flawed models and assumptions;
- an inability to handle a voluminous amount of business;
- challenges from high levels of fraud and lax mortgage underwriting;
- insufficient regulation;
- conflicts of interest involved in both rating and helping to design the same securities;
- conflicts of interest in the provision of ancillary services to issuers whose securities they rate; and
- limited liability under the First Amendment.[153]

While not all of these conditions apply exactly to the proxy advisory industry or to each of the firms in it, what is striking is the number of parallels between the two industries. Section VII of this study will discuss how the regulatory regime imposed on credit ratings agencies may be applicable to the proxy advisory industry.

VI. Impact of Significant Inaccuracies and Lack of Transparency in Proxy Analyses

One of most troubling developments with respect to proxy advisory firm analysis is the number and scope of inaccuracies in the research reports they produce on corporate issuers and a general lack of transparency in many of the methodologies, metrics and decision processes utilized by them to make voting recommendations. Because proxy analysis is largely concentrated in a few firms, the potential impact of these inaccuracies on the proxy voting system is substantial. Moreover, this is compounded when the substantial increase in the volume of votes and the import of those votes is considered. Recent survey data from the Center On Executive Compensation, presented below, highlights the frequency and types of inaccuracies found in proxy analyses on compensation issues. This chapter will also discuss potential reasons for the inaccuracies, and the potential impact of the lack of transparency on voting outcomes.

A. Potential Reasons for Inaccuracies

A number of reasons have been proffered for the significant level of inaccuracies found in reports produced by the proxy advisory industry. The most frequently cited reasons are lack of adequate resources and quality control procedures, pressures on the industry to reduce costs and the extremely short turnaround time available for proxy analyses.

Lack of adequate resources and quality control. Perhaps the greatest reason why errors and inaccuracies have proliferated in proxy analyses is a lack of resources to deal with the sheer volume of data and information processed by these firms. The largest proxy advisor, ISS, claims it provides proxy analysis on nearly 40,000 company meetings in more than 100 developed and emerging markets worldwide. The collection and processing of data for these companies encompassing management and shareholder proposals, financial performance, compensation plans and amounts, officers and directors, boards and board committees, anti-takeover and bylaw provisions, auditors, social and environmental performance and other governance issues is a monumental task.

Perversely, the trend toward regulators requiring greater volumes of disclosure by companies and more corporate accountability to shareholder votes, particularly in the United States and Europe, has greatly expanded the information processing and analytic requirements needed to assess proxy issues.

To take one recent example, the SEC issued new rules in 2006 requiring companies to disclose considerably more information in the Compensation Discussion and Analysis (CD&A) sections of their proxy statements regarding various key elements of compensation policies, practices, objectives and performance, along with seven specific tables of compensation data. The new rules have unquestionably multiplied the amount of quantitative and qualitative data available to investors to assess corporate compensation issues. But the CD&A section in large company proxy statements has now grown to an average of 26 pages.[154] As a consequence, a proxy advisory firm, such as ISS, that attempted to cover more than 10,000 domestic companies (or a large and highly indexed investing institution that attempted to do its own compensation analysis) could potentially face the prospect of reading and digesting hundreds of thousands of pages of CD&A discussion and compensation tables merely to understand company compensation plans and practices – and that does not account for any independent analysis of these arrangements.

Extrapolating this single example of how proxy research needs have snowballed from CD&A filings to the other disclosures that have been, or are in the process of being, required by the SEC in proxy statements – including those on audit firms and procedures, use of compensation consultants, director qualifications, risk management and oversight and board leadership – makes it easy to comprehend why many institutional investors have chosen to outsource corporate governance and proxy research.

To cope with the massive amount of data collection and analysis required to analyze proxy issues at thousands of companies, the proxy advisory firms have, in turn, largely outsourced their own "data mining" operations. As noted in Chapter III, ISS maintains a data collection and research operation center in the Philippines with more than 150 employees. Other proxy advisors utilize third-party contract firms, some of them located overseas, to procure and extract proxy statement information from public company filings.

The need to collect ever greater amounts of data and the trend toward outsourcing this task no doubt contribute to the potential for errors in proxy research. In addition, because of the seasonal nature of proxy analysis work, with a large fraction of U.S. public

company proxy filings taking place in a few months in the spring of each year, a considerable amount of the data collection and analysis work that remains is handled by temporary employees at the major proxy advisory firms. As participants in an investor roundtable sponsored by the Millstein Institute for Corporate Governance and Performance noted, this heavy reliance on temporary employees inevitably has led to concerns about the quality of the services being performed:

> Nevertheless, there is concern whether someone who may have limited, or no, business or proxy experience can make informed and appropriate voting recommendations. More than one investor present was uneasy about whether relying on the advice of inadequately resourced providers meant that they were not properly discharging their duties.[155]

Industry cost pressures. The problem of a lack of adequate resources to prevent errors and inaccuracies in proxy research reports has likely been exacerbated in recent years by pressures on the proxy advisory firms to increase profitability in order to service debts incurred in their acquisitions (in the case of the largest firms) or to stem operating losses (at smaller firms). MSCI, for instance, announced in a regulatory filing in July 2010 that it was eliminating 70-80 jobs in a "first round" of cuts associated with its purchase of RiskMetrics Group and that a second round of restructuring changes was expected to be completed by the end of the first quarter of 2011.[156]

Short turnaround time for analyses. Another frequently mentioned reason for inaccuracies in proxy analyses is the very tight time-frame under which proxy advisory firms operate in producing their reports for clients. Under corporate state law, issuers must generally provide written notice to shareholders of the annual meeting within a fixed number of days before the date of the meeting.

For instance, Delaware corporate law requires notice of the annual meeting at least 10 days, but no more than 60 days, before the meeting. Under federal regulations, issuers using internet-based distribution of proxy materials must post these materials at least 40 days before the meeting date. But many institutional investors expect proxy advisory firms to provide them with research reports on matters to be voted on at annual meetings at least several weeks before the meeting date. Therefore, proxy advisory firms typically have a narrow window of time between when they obtain access to many proxy statements and when their reports must be made available to clients.

Within this window, some – but not all – proxy advisory firms endeavor to make draft reports available to companies in order to

allow companies to comment on these drafts and any inaccuracies in them. A frequent complaint from issuers, however, is that the proxy advisory firms that do have such review procedures require any comments back from issuers within an unrealistic one- or two-day time-frame, which may occur over a weekend.

B. Center On Executive Compensation Research on Inaccuracies

The Center On Executive Compensation and its parent organization, HR Policy Association, conducted two member surveys in 2010 designed to gather data on the prevalence of inaccuracies in research by the proxy advisory firms on compensation-related matters.

In one survey, conducted in August 2010, the HR Policy Association surveyed Chief Human Resource Officers regarding various aspects of their companies' experiences with proxy advisory firms. Of those responding, 53 percent said that a proxy advisory firm had made one or more mistakes in a final published report on the company's compensation programs. The most common types of inaccuracies found were: improper peer groups or peer data (19%), erroneous analysis of long-term incentive plans (17%), and inaccurate discussion of a company policy, plan or benefit based on provisions no longer in effect (15%).[157]

In response to a question about whether proxy advisory firms were using proper peer groups in evaluating compensation, 57 percent of survey respondents said that a proxy advisory firm had used a compensation peer group in a preliminary draft of a report that failed to take into account the company's size, industry, complexity or competition for talent. Of the firms that indicated the use of such an inappropriate peer group, 96 percent indicated that the peer group was not adjusted in the final version of the report.[158]

Proper selection of industry peers is a critical component of pay analysis, because peer groups are heavily relied upon by both compensation committees and proxy advisory firms in their analysis of executive compensation. At companies where proxy advisory firms deem compensation to be excessive relative to industry peers and to performance, proxy advisors often recommend that investors withhold voting in favor of board nominees who serve on the compensation committee.

Similarly, in a February 2010 survey of its Subscribers, the Center asked about the types of inaccuracies companies had experienced in 2008 or 2009 in a draft version of a proxy advisory service report regarding compensation programs. A sample of the

descriptions provided by companies of these inaccuracies is shown below in Table 3. [159]

TABLE 3: Sample Compensation-Related Inaccuracies Reported by Center On Executive Compensation Members in 2010 Survey

- ISS and Glass Lewis significantly misstated the stock value of three of our executives from the Summary Compensation Table in 2008.
- We experienced six inaccuracies in ISS' draft report for the 2009 proxy season. They related to the following: (i) vesting of performance shares, (ii) disclosure of non-equity bonus targets, (iii) incorrect attribution of aircraft gross-ups to one officer, (iv) payment of dividend equivalents on unvested performance share awards, (v) performance share targets at which payouts are made, and (vi) stating that our CEO was "entitled" to use company aircraft for personal travel, when in fact he is required to do so.
- Both Proxy Governance and ISS miscalculated the total compensation by using the maximum opportunity for our performance share plan grant (three times fair market value on date of grant) compared with the target. Proxy Governance did make the correction; however, ISS did not correct the report, but merely added language to their report about the change in the SEC rule.
- We found problems in report and told them, but they did not fix the discrepancies with the items in our proxy. When we asked them about it later, their response was that they only change items that they feel are significant or pertinent to the shareholders' understanding of the information provided in the report.
- In 2009, Glass Lewis elected to withhold against reelecting our Compensation Committee members based on our pay compared to their peer group. We noted that their analysis was based on our 2008 data versus the peer 2007 data.
- ISS' draft last year was obviously a cut and paste from their report on another company as it included negative language about personal use of the company aircraft. Although we lease a fractional share of an aircraft, there was no personal use of the aircraft by any company executive.
- Glass Lewis did not calculate "pay for performance" correctly which led to a "D" compensation rating.
- ISS characterized one gross-up on a perk as though it were a current, ongoing benefit that applied to everyone. We corrected them stating that the gross-up provision has been discontinued prospectively.

Source: Center On Executive Compensation survey, February 2010

C. Lack of Transparency in Proxy Analyses and Recommendations

In addition to the issue of inaccuracies in their analyses, many observers have noted concerns about the lack of transparency of proxy advisors in terms of their voting determinations, methodologies and their use of proprietary models on issues such as compensation. Issuers are concerned that many recommendations from proxy advisors are based on a "one-size-fits-all" governance approach that does not capture the differences in company situations or approaches. At the same time, there are concerns that proxy advisors utilizing a "case-by-case" or individualized approach to their recommendations can be inconsistent in how they treat companies or can be opaque with respect to their decision process on any particular issue.

Similarly, there are concerns that the proxy advisors are unwilling to make their models completely transparent. In the area of compensation, for example, the major proxy advisory firms rely on proprietary models that relate a company's executive pay to those of its peers and to the company's performance relative to peers. These models form the basis for proxy advisors' recommendations regarding many compensation-related ballot items. But proxy advisory firms say that many of the parameters of these models, such as the weightings of various performance factors utilized as inputs into the models, are considered proprietary and are not made available publicly. This effectively results in a "black box" situation for companies attempting to understand why a proxy firm may recommend against their compensation plans.

D. Impact of Inaccuracies and Lack of Transparency on Voting Outcomes

The impact of inaccuracies in reports and the lack of transparency in how proxy advisors make their recommendations raise serious issues for U.S. capital markets. Because institutional investors have come to rely so heavily on the information and recommendations provided by proxy advisory firms – and because proxy votes on many issues, from director elections to approval of compensation plans, are no longer perfunctory ratifications of management's positions – errors or inaccuracies in proxy reports are now capable of causing significant harm to corporations and their investors.

In recent years, for instance, the percentage of equity plans that ISS has recommended voting against has fluctuated between 30 and 40 percent. If any significant percentage of these recommendations was based on erroneous or inaccurate data, as the Center's survey data discussed earlier suggests, it would imply that inaccuracies at ISS are negatively impacting the compensation programs at a meaningful number of companies. As noted earlier, this influence is poised to grow with the addition of say on pay, proxy access and majority voting.

The seriousness with which many corporations are taking the issue of inaccuracies in proxy analyses is illustrated by the fact that some companies now feel compelled to respond to inaccuracies in proxy reports by filing detailed rebuttals in their own public securities filings. For example, in May 2009, Target Corporation responded to what it said were numerous inaccuracies in a report issued by ISS/RiskMetrics related to a controversial proxy fight at Target by issuing a seven page white paper to its shareholders discussing what it described as "flaws" in the ISS analysis of the proxy fight. Among the inaccuracies that Target cited in the filing were: a mischaracterization of the company's real estate strategy as "atypical" among major retailers, a flawed calculation of compound annual growth rates, failure to provide full context in quoting a corporate governance expert and mischaracterizing the company's nominating practices.[160]

E. Conclusion

Proxy advisory firms have a fiduciary duty to provide accurate and reliable analyses on executive compensation and governance practices of corporate issuers to their institutional investor clients. Based on proxy advisory firm reports, corporate issuers are increasingly concerned that proxy advisors are transmitting inaccurate information to institutional investors that could adversely impact investors' decisions on pay and governance matters. Because the potential impact on the companies is substantial, the Center believes that accuracy of reports should be more closely monitored and regulated by the SEC to minimize adverse impacts on pay for performance.

VII. The Existing Regulatory and Legal Framework for Proxy Advisors

Given the reliance of institutional investors on proxy advisory firms, and the importance of proxy voting to the operation of capital markets and corporate governance, one would expect that the advisory industry would be heavily regulated. However, that is not the case. Proxy advisory firms are subject to very little regulation. The principal regulatory framework governing the industry is the Investment Advisers Act, but proxy advisers can essentially choose whether to be covered by the Act's regulations.

At present, the only real oversight of proxy advisors would come from institutional investors, who are required to monitor the activities of proxy advisors and ensure the independence of the recommendations made by them. Yet, institutional investors have little incentive to monitor the advisory firms carefully, since proxy advisory firms offer them an efficient and cost-effective way to discharge their fiduciary duties to vote proxies in the interest of their clients. This seetion will discuss the existing regulatory and legal framework governing the activities of proxy advisory firms.

A. The Investment Advisers Act of 1940

The principal legal and regulatory framework governing the activities of proxy advisory firms is the Investment Advisers Act of 1940 (the Act). A person or firm is considered an "investment adviser" under the Act if, for compensation, they engage in the business of providing advice to others as to the value of securities, whether to invest in, purchase, or sell securities, or issue reports or analyses concerning securities.[161] The SEC has stated that it considers proxy advisory firms to meet the definition of an investment adviser "because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities."[162] The SEC has further stated that, as investment advisers, "proxy advisory firms owe fiduciary duties to their advisory clients."[163]

The U.S Supreme Court has articulated the fiduciary duty of investment advisers as a requirement that advisers act in the best interest of clients and disclose all conflicts of interest.[164] The SEC has also stated that a "proxy advisory firm has a duty of care requiring it to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."[165]

Although proxy advisory firms meet the definition of investment advisers, they have some discretion whether to register under the Advisers Act. The Act contains a prohibition against registering with the SEC for firms that have less than $25 million in assets under management – a provision Congress established in 1996 to divide regulatory responsibility for advisers between the SEC and the states.[166] Within a year of the recent passage of the Dodd-Frank Act, this threshold will rise to $100 million for most investment advisers if they are subject to regulation and examinations in their home states. This prohibition would apply to most proxy advisors because they typically do not manage client assets.

To make matters more confusing, the prohibition is subject to several exemptions, including one that allows firms to register if they serve as consultants to pension plan clients with a minimum of $50 million in assets.[167] As of December 2010, three proxy advisory firms – ISS, Proxy Governance and Marco Consulting Group –were registered with the SEC as investment advisers using this "pension consultant" exemption.[168]

Some provisions of the Investment Advisers Act apply to proxy advisory firms regardless of whether they have registered with the SEC. In particular, section 206 of the Act prohibits an adviser from engaging in "any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client."[169] Proxy advisors that elect to register as investment advisers are subject to a number of additional requirements, including requirements to:

- file and make certain disclosures on an annual Form ADV;
- adopt, implement and annually review an internal compliance program consisting of written policies and procedures;
- designate a chief compliance officer to oversee its compliance program;
- establish, maintain and enforce policies preventing misuse of non-public information; and
- create and preserve certain records that are available for SEC inspection.

According to a GAO study of proxy advisors in 2007, the SEC's Office of Compliance Inspections and Examinations monitors the operations and conducts inspections of registered investment advisors, including the registered proxy advisory firms.[170] As part of these examinations, the SEC stated, it "may

review the adequacy of disclosure of a firm's owners and potential conflicts; particular products and services that may present a conflict; the independence of a firm's proxy voting services; and the controls that are in place to mitigate potential conflicts."[171]

The GAO study noted that it did not independently assess the adequacy of the SEC examinations, but that the SEC reported that it did not identify any major violations of federal securities laws as part of its examinations of proxy advisors and had not initiated any enforcement actions against these firms.[172]

In May 2009, the SEC did settle an enforcement action against an investment adviser, INTECH Investment Management LLC and its COO related to that adviser's policies, procedures and failure to disclose to clients a material conflict of interest related to its proxy voting policies.[173] INTECH had been using a specialized proxy service provided by ISS designed to follow AFL-CIO voting recommendations. The SEC found that INTECH had violated Rule 206(4)-6 of the Investment Advisers Act, because its written policies and procedures did not address material conflicts that arose between INTECH's interests and those of its clients who were not pro-AFL-CIO, and that it did not sufficiently describe to clients its voting policies and procedures. INTECH settled the case after consenting to a cease-and-desist order and the payment of civil penalties of $300,000 by the company and $50,000 by its COO.[174]

The INTECH settlement is important, because it establishes that the SEC is prepared to enforce the duty that exists for institutional investors to monitor the conflicts of interest that can arise in their own proxy voting policies and procedures. It does not speak directly, however, to the willingness of regulators to take enforcement actions against the proxy advisors themselves or against institutional investors for failure to monitor the conflicts of interest at proxy advisors.

B. Rules Governing Proxy Solicitation

The SEC has noted that because of the broad definition of "solicitation" under the Securities and Exchange Act of 1934, the provision of proxy advice constitutes a solicitation that normally would subject the proxy advisory firms to the information and filing requirements under the proxy rules in the Exchange Act. In 1979, however, the SEC adopted a rule exempting proxy advisors from these informational and filing requirements, providing that certain conditions were met.

Specifically, the advisor:

- must render financial advice in the ordinary course of its business;
- must disclose to its client any significant relationship it has with the issuer or any of its affiliates, or with a shareholder proponent of the matter on which advice is given, in addition to any material interest of the advisor in the matter to which the advice relates;
- may not receive any special commission or remuneration for furnishing the proxy voting advice from anyone other than the recipients of the advice; and
- may not furnish proxy voting advice on behalf of any person soliciting proxies.[175]

The SEC has noted, however, that while proxy advisory firms are exempt from the informational and filing requirements governing proxy solicitation, they remain subject to an Exchange Act prohibition against false and misleading statements.[176]

C. Fiduciary Duty Only to Clients

Although the SEC has stated that proxy advisory firms owe fiduciary duties to their clients, some observers and legal scholars have questioned whether, in practice, such duties serve as any real restraint on the proxy advisory industry. Corporate managers and directors owe clear fiduciary duties of care and loyalty to the corporation and its stockholders, which are designed to prevent the abuse of power by agents of the corporation. As Delaware Vice Chancellor Leo Strine has noted, however, "[u]nlike corporate managers, neither institutional investors, as stockholders, nor ISS, as a voting advisor, owe fiduciary duties to the corporations whose policies they seek to influence."[177] According to one law professor, therefore, the trend toward institutional investors' greater reliance on the voting recommendations of proxy advisors, as opposed to those of corporate managers, essentially means they are "replacing agents who are constrained by relatively strong fiduciary duties with an agent who has relatively weak fiduciary duties."[178]

The Department of Labor (DOL) has recently inserted itself into the regulatory landscape of proxy advisors. On October 22, 2010, DOL proposed regulations that will expand the categories of individuals who would be considered fiduciaries under the Employee Retirement Income Security Act of 1974, as amended (ERISA).[179] The plain language of the regulations indicates that ISS and Marco Consulting would fall within the purview of the regulations as they are SEC-registered investment advisers to the extent the proxy advisor effectively exercises discretion over the

proxy voting decision.[180] The Preamble to the proposed regulations, however, specifically notes that "[the provision would apply to] advice and recommendations as to the exercise of rights appurtenant to shares or stock (*e.g.*, voting proxies) . . ."[181] It is unclear how the proposed regulations will be interpreted and whether they will apply only those firms registered as investment advisors with the SEC or all proxy advisory firms.

The implications of the proposed regulations are extensive. If finalized, proxy advisory firms would arguably become subject to the wide range of fiduciary duties and obligations under ERISA, such as the duties of loyalty and prudence, and would be prohibited from engaging in self-dealing transactions. ERISA imposes significant civil penalties and excise taxes for fiduciary violations. As such, categorizing proxy advisory firms as ERISA fiduciaries may cause the ISS business model to become obsolete as the business model itself presents inherent conflicts of interest. ERISA would certainly consider it a breach of fiduciary duties for a firm, such as ISS, to provide consulting services to a corporate client at the same time that ISS is providing another client with "independent" proxy voting research and recommendations about the corporate client receiving consulting services. Until final regulations are released, we can only speculate as to whether and the extent of the regulatory framework that will be imposed upon proxy advisory firms under ERISA.[182]

VIII. Proposals Addressing Proxy Advisor Conflicts and Lack of Transparency

Proxy advisory firms play a central role in the proxy voting process and wield significant influence over the structure of executive compensation and corporate governance at most companies. Lacking sufficient regulatory oversight, the industry has developed organically. As a result, significant problems have developed regarding conflicts of interest, lack of transparency and analytical inaccuracies that could have a detrimental impact on shareholder value.

There is a growing consensus that greater regulation of the industry, ranging from elimination of certain conflicts to clearer fiduciary responsibility and disclosure regarding their processes, is necessary to ensure that the information provided by proxy advisors is accurate and reliable. Notably, the International Organization of Securities Commissions (IOSCO), the international organization of securities regulators, recently revised its principles of securities regulation based on the lessons learned from the financial crisis and, among its new principles, was one directed at organizations like proxy advisors. The IOSCO stated that "entities that offer investors analytical or evaluative services should be subject to oversight and regulation appropriate to the impact their activities have on the market or the degree to which the regulatory system relies on them."[183] This section will analyze the leading proposals for remedying the perceived problems at proxy advisory firms through greater regulation.

A. The Proxy Advisory Industry Should Be Regulated by the SEC

Most proposals calling for increased regulation of the proxy advisors recognize the primacy of the SEC's regulatory authority over the industry. As a result, the most effective approach to regulation would be to have the SEC be responsible for additional regulation of the industry. The SEC has statutory authority over proxy advisors, which is highlighted by the fact that it has established exemptions for them from various SEC regulations – such as those governing proxy solicitations – that would otherwise impose significant administrative burdens on proxy advisory firms. As some observers have noted, the SEC could modify these exemptions to make their availability contingent on a proxy advisor meeting various standards or conditions. The SEC already has direct regulatory authority over two proxy advisors – ISS and Marco Consulting Group – that have voluntarily registered with the Commission as investment advisers.

B. Proposals Contained in the 2010 SEC Concept Release

On July 14, 2010, the Securities and Exchange Commission voted unanimously to issue a concept release on various aspects of the U.S. proxy voting system, opening its first comprehensive review of the proxy system in nearly 30 years. "The proxy is often the principal means for shareholders and public companies to communicate with one another, and for shareholders to weigh in on issues of importance to the corporation," said SEC Chairman Mary L. Schapiro in announcing the release. "To result in effective governance, the transmission of this communication between investors and public companies must be – and must be perceived to be – timely, accurate, unbiased, and fair,"[184] Schapiro said.

Regarding proxy advisors, Schapiro noted that both companies and investors "have raised concerns that proxy advisory firms may be subject to conflicts of interest or may fail to conduct adequate research and base recommendations on erroneous or incomplete facts."[185] Twenty-two pages of the 151-page concept release were devoted to a discussion of proxy advisors and potential regulatory remedies for conflicts of interest, lack of transparency and inaccuracies in proxy analyses and recommendations.

With respect to conflicts of interest, the SEC release suggests that one possible solution could be for the SEC to revise or provide interpretive guidance regarding the proxy rule exemption in Exchange Act Rule 14a-2(b)(3), under which a firm providing proxy advice must disclose to its clients "any significant relationship" it has with the issuer, its affiliates or a shareholder proponent. At present, some proxy advisors, including ISS, utilize a blanket disclosure in their reports to alert investors that they may have done business with the corporation that is the subject of the report and direct readers to an email address where they can ask for more information.

Alternatively, the SEC concept release suggests that the Commission could take three other approaches to addressing conflicts of interest at proxy advisors:

- establish additional rules making it likely that proxy advisors would be required to register as investment advisers;
- provide additional guidance on the fiduciary duty of proxy advisors or issue rules requiring specific disclosures of conflicts by registered investment advisors; or
- issue regulations similar to those addressing conflicts by the credit ratings agencies, such as the prohibition of certain conflicts of interest and requiring specific disclosures and procedures to manage others.

The release also discusses several proposals for addressing concerns about the accuracy and transparency of data and vote recommendations by proxy advisors, including:

- requiring increased disclosure of the extent of research involved and the procedures and methods used to determine ratings or recommendations;
- requiring disclosure of policies and procedures for interacting with issuers, informing issuers of vote recommendations and handling appeals of recommendations; and
- requiring proxy advisors to publicly file vote recommendations with the Commission on a delayed basis.

The comments received from the concept release will be used to determine whether the SEC will pursue additional regulation of proxy advisory services and form the basis for proposed rules on the subject.

C. Other Regulatory Proposals

Several variations of the ideas contained in the SEC concept release related to regulation of proxy advisors, as well as other novel regulatory ideas, have been circulated in recent years. The most prominent of these proposals are discussed below, including adoption of the credit ratings agency regulatory model, creation of public oversight board, development of a unique regulatory framework for the industry, and self-regulation through a voluntary code of conduct.

Adoption of Credit Ratings Agency Regulatory Model. As discussed in Chapter IV of this paper, there are a number of parallels between the conflicts of interest and business model issues associated with the credit ratings agencies and those associated with proxy advisory firms. Perhaps the most widely discussed model for enhancing regulation of the proxy advisors involves imposing a regulatory regime similar to that which Congress and the SEC have mandated for credit ratings agencies. The SEC received initial authority to regulate credit ratings agencies under the Credit Rating Agency Reform Act of 2006, and formally voted in June 2008 to propose a series of reforms for credit ratings agencies. Many of these proposals were codified in 2010 under the Dodd-Frank Act, which imposes substantial new controls and transparency requirements on credit ratings agencies. Table 4 below lists a number of the new provisions of the Dodd-Frank Act that apply to credit ratings agencies along with an analogous potential regulation that could be applied to the proxy advisory firms.

The Dodd-Frank Act also created a new office at the SEC charged with overseeing standards related to credit ratings agencies and with conducting inspections. It also gave the SEC the authority to suspend or revoke the registration of credit ratings agencies for failure to satisfy certain requirements. In addition, Dodd-Frank required the SEC and the Comptroller General to undertake various studies of the credit rating agencies and their processes. Finally, the Dodd-Frank Act rescinded an exemption from the Securities Act that shielded credit ratings agencies from legal liability related to the inclusion of credit ratings in public security registration statements and confirmed the ability of investors to seek civil actions against credit ratings firms under the Exchange Act.

Creation of a Public Oversight Board. Another regulatory approach that has been suggested for the proxy advisory industry is the creation of a federal oversight board similar to the Public Company Accounting Oversight Board (PCAOB), which was

created in the wake of the Enron and WorldCom accounting scandals to oversee the public auditing firms. Professor Tamara Belinfanti of New York Law School argues in a 2009 paper that such a board could be "designed to provide systematic accountability of proxy advisors."[186] The general features and mandate of the PCAOB could be replicated for the proxy advisors, including auditing and ethics standards, inspections, registration requirements and the ability to investigate and discipline registered firms, according to Belinfanti. She adds that:

> The sentiments underlying the creation of the PCAOB are similar in contour and substance to the sentiments expressed by those concerned about the current landscape in the proxy advisory and corporate governance industry. Like auditors, ISS and other proxy advisors hold positions of significant perceived authority and expertise on which the market relies. And like auditors in the wake of Enron and WorldCom, there is a growing sentiment that an unrestrained and unaccountable proxy advisory industry is a disaster waiting to happen.[187]

The parallels to prior meltdowns and the impact of the PCAOB make this option worth considering.

TABLE 4:

Regulatory Requirement for Credit Ratings Agencies in Dodd-Frank Act	Similar Potential Regulatory Requirement for Proxy Advisors
• establish internal controls for monitoring adherence to established policies and procedures	• same
• submit annual compliance reports to the SEC	• same
• take actions to prevent sales and marketing considerations from affecting ratings	• take actions to prevent sales and marketing considerations from affecting voting recommendations
• set qualifications standards for credit analysts	• set qualification standards for proxy analysts
• establish procedures for assessing possible conflicts of interest with former employees	• same
• maintain an independent board or board committee tasked with certain responsibilities related to the credit ratings agency business	• maintain an independent board or board committee tasked with certain responsibilities related to the proxy advisory business
• publicly disclose ratings methodologies and a description of the underlying data used in the ratings process	• publicly disclose vote methodologies and description of underlying data used in deriving vote recommendations
• periodically disclose information on the historical accuracy of credit ratings	• periodically disclose information on the accuracy of vote recommendations

Development of a Unique Regulatory Framework for Proxy Advisors. Rather than adopting a regulatory framework designed for other industries, some observers have proposed that the SEC develop a unique regulatory scheme designed specifically for proxy advisors. "At a minimum, all proxy advisory firms should be required to register as investment advisers, and the SEC should develop a unique regulatory framework for these firms under the Investment Advisers Act of 1940," states a paper published in March 2010 by two prominent business groups.[188] The paper also recommends:

- public disclosure of the governance models used by proxy advisory firms, including guidelines, standards, methodologies and assumptions used in developing voting recommendations;
- establishment of a more robust due diligence process and greater disclosure for institutional investors regarding proxy voting;
- public disclosure by proxy advisors of all vote recommendations and decisions;
- opportunities for public company input on draft proxy reports and recommendations; and
- public disclosure by proxy advisors of all errors made in executing or processing voting instructions.

In public comments to the SEC concept release filed on Aug. 5, 2010, the Center for Capital Markets Competitiveness (CCMC) of the U.S. Chamber of Commerce makes a number of similar recommendations regarding transparency and disclosure and proposes that the SEC consider new rules governing proxy advisors designed to ensure that "proxy advisors do what they say they are in business to do."[189] The CCMC letter says that the SEC should require proxy advisors to have a process "that demonstrates due care towards formulating accurate voting recommendations when applied in the unique context of each individual company."[190] This could be accomplished through rules "similar to the government's use of the Administrative Procedures Act," the CCMC says, and this implementation process should be transparent.[191] "It should be apparent to the market, including the advisor's own clients, when a recommendation proves correct, and when it proves incorrect," the Chamber letter adds, noting that "one consequence of such transparency might be to encourage proxy advisors to compete with each other based on the *quality* of their voting recommendations."[192]

Greater Self-Regulation Through a Voluntary Code of Conduct. Finally, in addition to various proposals for greater government regulation of proxy advisors, some parties have advanced the idea of greater industry self-regulation through a standardized voluntary industry code of conduct. In 2008, the Millstein Center for Corporate Governance and Performance at the Yale School of Management held a roundtable workshop with institutional investors and proxy advisors and undertook independent research on the proxy system. This resulted in a policy brief that included a draft code of professional practices for the proxy advisory industry. "Considering the oft-repeated concerns that proxy advisors can appear opaque or conflicted, and the subsequent worry that conflicts of interest may affect the quality of voting recommendations, it is surprising that such a code has not yet been drafted," the policy brief stated.[193] "The adoption of an industry-wide code of conduct could bring more comfort to other market parties, including investors, issuers and other stakeholders, who would be able to compare the advisors' policies against an industry standard."[194]

The code of professional conduct developed under the auspices of the Millstein Institute was modeled after a code developed in 2004 by the IOSCO for handling conflicts of interest at credit ratings agencies. The code covered four principal areas: 1) quality and integrity of the recommendation process; 2) advisor independence and avoidance of conflicts of interest; 3) advisor responsibilities to clients and issuers; and 4) disclosure of the code of conduct.

The code contains more than 45 specific recommendations for proxy advisory firms within these four broad areas, a number of which have been incorporated into some of the regulatory proposals under consideration. Some of the proxy advisory firms made written responses to the Millstein Center that included statements suggesting they would implement at least some of the voluntary code of conduct suggestions.

D. Potential for Unintended Consequences from Enhanced Regulation of Proxy Advisors

While many industry participants are strongly in favor of greater regulation for the proxy advisory industry, some remain concerned that such a move could have negative unintended consequences, including creating increased barriers to entry for new firms, further entrenchment of ISS as the dominant presence in the industry and giving proxy advisory firms a government "seal of approval" that would enhance their power and credibility.

Many of the regulatory proposals for proxy advisors outlined in this section revolve around increased certification, procedural and public filing requirements that would likely increase costs for proxy advisory firms. The impact of these increased costs would likely be most significant, however, for smaller firms in the industry and potential new entrants, rather than on the industry leaders. With the possible exception of conflicts of interest, the problems in the proxy advisory industry "would not be solved, and may even be exacerbated, by SEC regulation," says Paul Rose, a law professor at Ohio State University, who notes a tendency for regulation to stifle, rather than promote, competition:

> SEC regulation of the industry may actually increase the market power of the few major corporate governance players. As Jonathan Macey has argued in the context of derivatives regulation (a much more competitive industry than governance ratings, at least in terms of the number of significant market participants), the fixed costs associated with regulation would serve as barriers to entry of new competitors in the market. This would be an especially unfortunate side-effect in a market that is already dominated by a single firm which competes with only a handful of others.[195]

A February 2010 Center survey of its Subscribers regarding regulation of the proxy advisors by a federal agency as a way of ensuring quality control by proxy advisors and reinforcing the integrity of the proxy voting process, found that nearly two-thirds of the respondents favored regulation. But a signifieant minority questioned the effectiveness of this approach or raised concerns about unintended consequences. One respondent stated a concern that regulation would amount to a "Good Housekeeping Seal of Approval" for proxy advisors that could give them "undue credibility." Another echoed this sentiment, stating that regulation "would give [advisors] even more legitimacy than they already have and could cause some shareholders to believe that because they are regulated by the SEC, their opinion should be given greater weight."[196]

E. The Need for Effective Enforcement

Despite legitimate concerns over the unintended consequences of regulation, a regulatory approach may be the most effective means to begin to unravel the web of conflicts and the inaccuracies in reports produced by the industry. Thus, whatever changes to regulation of the proxy advisory industry get made, effective enforcement will be a key element in their success.

To date, the proxy advisory firms that are registered as investment advisers have not been subject to significant SEC enforcement actions, despite considerable concern about conflicts of interest, lack of transparency and inaccuracies in their reports.[197] SEC enforcement in the proxy voting field to date has primarily focused on warning institutional investors of their duty to take reasonable steps to ensure that, when they use third-party proxy advisors, these advisors are independent and can make voting recommendations that are impartial and in the best interests of the investor's clients. In 2009, the SEC settled its first enforcement action against an investment adviser for not sufficiently describing its proxy voting policies and procedures and for failing to disclose a material conflict of interest.[198]

At least one observer has suggested that SEC enforcement could potentially become more robust if the SEC's Division of Corporate Finance took a greater role in regulating proxy advisors rather than deferring to the Division of Investment Management, which regulates investment advisers. Paul Rose, a law professor at Ohio State University, notes in a paper examining the corporate governance industry that the SEC's Division of Corporate Finance, which oversees corporate disclosure, including proxy statement and shareholder proposal reviews, has already issued rules to limit auditor and security analyst conflicts of interest. Rose argues that it could do so for proxy advisors as well. "It is possible that the Division of Corporation Finance would take a different view of ISS' potential conflicts than the Division of Investment Management," Rose writes, and "the Division of Corporation Finance is under no obligation to refrain from regulating the corporate governance industry nor from referring a conflicts matter to the SEC's Division of Enforcement if it perceives a problem with the industry's activities."[199] This approach would be consistent with the SEC's role as the protector of investors and with ensuring that information disclosed by corporations is being transmitted accurately to institutional investors.

IX. Potential for Addressing the Market Power of Proxy Advisors Through Increased Competition

An alternative or supplemental approach to increased regulation of the proxy advisory industry as the primary mechanism for addressing the substantial problems in the industry –including conflicts of interest, lack of transparency and concentrated market power – is to foster greater competition in the industry and expand voter participation. This section will discuss the need for greater competition in the industry and two prominent ideas for spurring competition and broader voter participation.

A. The Case for Greater Competition in the Proxy Advisory Industry

A common theme expressed by many who have an interest in the proxy voting system is the need for greater competition in the proxy advisory business because of the level of unchecked power of the largest proxy advisors. The relative lack of competition in the industry has been commented on in many studies of the industry, including the 2007 Government Accountability Office report, which noted that ISS had more clients than all of the other proxy advisory firms combined.[200] The GAO reported that many of the institutional investors it had interviewed believed "that increased competition could help reduce the cost and increase the range of available proxy advisory services."[201] It also noted, however, that significant barriers to new competition existed in the industry, including the need to offer comprehensive company research coverage and sophisticated database and vote execution platforms. Moreover, it stated that "because of its dominance and perceived market influence, corporations may feel obligated to be more responsive to requests from ISS for information about proposals than they might be to other, less-established proxy advisory firms, resulting in a greater level of access by ISS to corporate information that might not be available to other firms."[202]

A number of academics have also written about the relative lack of competition for ISS. Tamara Belinfanti, a professor at New York Law School, has postulated that "the anemic level of competition" currently present in the proxy advisory industry is due to significant "first mover" advantages for ISS as well as significant barriers to entry.[203] Among the "first mover" advantages that accrue to ISS, Belinfanti says, are network effects,

consumer switching costs, acquisition of resources and assets and technology preemption. Regarding network effects, she notes that "on the institutional client side, the more mutual funds that use ISS' services, the more a mutual fund can feel secure in relying on ISS' advice because it is assured that its voting practices are in line with the industry."[204] Among the barriers to entry cited by Belinfanti are a need to provide company coverage that matches that provided by ISS (more than 40,000 companies in 110 countries); the development, implementation and maintenance of sophisticated technology platforms; and the costs for clients of switching vote execution services.

While first mover advantages and barriers to entry have no doubt played a role in ISS maintaining a dominant position, as discussed in Chapter III, the firm's strategy of habitually buying its largest rivals has also been a key factor in its market dominance. Proxy Governance Inc., a former ISS competitor, summed up the competitive situation regarding ISS in a letter to the Millstein Institute and the SEC as follows: "[i]f there is one issue on which virtually all market participants (with the possible exception of RiskMetrics/ISS) would seem to agree, it is that there should be more than one proxy advisor and that the perpetuation of the near-monopoly status of RiskMetrics/ISS is not in the long-term interests of investors or our capital markets."[205] This statement is particularly noteworthy as Proxy Governance, Inc. abruptly ceased its operations at the end of 2010, leaving most institutional investors with two options for proxy advisory services: ISS or Glass Lewis.[206] Proxy Governance entered into an agreement with ISS' competitor, Glass Lewis, to assume all of their customer contracts.[207]

While the need for greater competition in the proxy advisory field is evident, the willingness of investors to support more than a few firms in the industry remains very much in question. The GAO study acknowledged this dilemma, noting that some of the investors it had spoken with "questioned whether the existing number of firms is sufficient, while others questioned whether the market could sustain the current number of firms."[208]

In comments to the SEC, a law firm made a similar point stating that "[g]iven the costs attendant to establishing a proxy adviser and coverage of even the most widely held stocks, we are highly skeptical that there will be new market entrants, and we believe that as more mutual funds engage proxy advisers to assist in developing and implementing proxy voting policies and procedures the virtual monopoly enjoyed by the current providers in the proxy adviser market will only grow more powerful."[209] Meanwhile, the SEC, as part of its review of the U.S. proxy

system, has taken note of the dominant market position of ISS among proxy advisors and asked for comments on how this may he affecting the quality of voting recommendations from ISS and other proxy advisors.[210]

B. A Non-Profit Utility Model for Proxy Services

In addition to the perceived need for more competition in the proxy advisory field – and a diminution in the market power of ISS – some industry participants have articulated the need for a different business model for proxy advisors to hetter serve the public interest and to remove conflicts of interest associated with the fact that all of the major proxy advisors are commercial businesses. Specifically, an argument has heen made that the interests of investors, issuers and the public would he better served with a system where the provision of proxy research and recommendations was treated like a public utility function – with low prices, heavily regulated procedures and no conflicts – rather than as a specialized consulting service.

As noted in Chapter III, one proxy advisor, Proxy Governance Inc., had explored the concept of reconstituting itself into a non-profit entity called the Proxy Governance Institute. In a June 2010 public letter to the SEC, Proxy Governance said that the "underlying premise of this concept is that corporate governance and, by extension, proxy voting are matters of public policy with important societal implications that transcend any one company, shareholder or group of shareholders."[211] The letter stated that the new institute would serve "individual and institutional investors, issuers and the public interest by providing low-cost – and, in some cases, free – independent and conflict-free corporate governance advice and information." In a concept summary attached to the letter, Proxy Governance outlined a number of key points regarding its concept and business model for the Institute.

The letter from Proxy Governance to the SEC about its proposal for the Institute also reinforces the notion that the competitive landscape in the proxy advisory industry is difficult for smaller firms. The letter states that "the business incentives for providing ready access to quality corporate governance and proxy voting services are substantially narrower than the wide-ranging need for these services." The letter adds that while its "approach to governance, its work product and research and voting technology are highly regarded, its influence in addressing these challenges has not met expectations."[212] It is ironic that this proponent of increased competition in the proxy advisory industry recently succumbed to the realities of a tough economy and an industry monopolized by one firm. Having struggled for quite

some time, Proxy Governance ceased its operations at the end of 2010, entering into an agreement with Glass Lewis to take over their customers' proxy voting and advisory services contracts.[213]

Several other firms have also recently entered the proxy research or voting information market using a non-profit structure. The Sustainable Investments Institute (Si2) supported primarily by a group of college and university endowments, provided proxy research on social and environmental issues during its first proxy season in 2010. And several organizations that seek to assist retail investors in voting have also chosen a non-profit structure. In some ways, the founding of Si2 and the proposed reconstitution of Proxy Governance as a non-profit represent a circling back to the origins of the proxy advisory industry when the Investor Responsibility Research Center operated as a not-for-profit.

One aspect of the Proxy Governance Institute proposal that raised an interesting fiduciary question is the concept of giving "open access" to the Institute's voting platform for third parties to express their corporate governance views or recommendations. By allowing various institutions to display their voting patterns or recommendations on its platform, the Institute would make it easier for institutional investors to follow the voting advice of other like-minded institutions. Or, taking the concept one step further, an investor could choose to vote according to the consensus pattern of vote recommendations from multiple institutions (and/or proxy advisors) that the investor selected because it believed those institutions had the most thoughtful approach to proxy voting. One question that arises from this approach is whether an institutional investor that chose to essentially follow the voting policies and recommendations of another institution (or a group of institutions) would be meeting its fiduciary duties with respect to proxy voting.

Some observers have argued that the fiduciary protection that an institutional investor should receive from following the voting recommendations of another institutional investor that had taken a careful and diligent approach to proxy voting should, if anything, be superior to that received from following the advice of a proxy advisor – if for no other reason than that the other institution's voting would be based on having an actual financial stake in the voting outcomes. It is believed that this issue has never been litigated and that the SEC has not offered any guidance on it. The issue is important, however, because it has the potential to diminish the influence of proxy advisory services by allowing investors to readily meet their fiduciary obligations for proxy voting in a cost-effective manner without hiring a proxy advisory firm.

C. Mechanisms to Promote Greater Participation in Proxy Voting by Retail Investors

Another potential way to bring greater competition to the proxy voting market involves the promotion of higher participation rates and better informed voting by retail investors. This issue has received increasing attention over the last two years for several reasons. First, there has been a noticeable falloff in the already low historical level of proxy voting by retail investors in recent years due to changes in how issuers are allowed to disseminate proxy information. At the same time, however, certain technological and infrastructure developments are underway that have the potential to greatly facilitate the ability of retail investors to utilize what has been termed "client-directed voting."

Proxy voting by retail investors has historically been at a much lower participation rate than that for institutional investors, many of which have a fiduciary obligation to vote. A number of academics have suggested that this low voting participation is a rationale response by retail investors to their limited information and impact on voting results. Stephen Bainbridge, a law professor at the UCLA School of Law, has noted:

> Given the length and complexity of corporate disclosure documents, especially in a proxy contest where the shareholder is receiving multiple communications from the contending parties, the opportunity cost entailed in becoming informed before voting is quite high and very apparent. In addition, most shareholders' holdings are too small to have any significant effect on the vote's outcome. Accordingly, shareholders can be expected to assign a relatively low value to the expected benefits of careful consideration. Shareholders are thus rationally apathetic. For the average shareholder, the necessary investment of time and effort in making informed voting decisions simply is not worthwhile.[214]

According to data provided by Broadridge Financial Services, among retail investor accounts in 2009, 17 percent of Objecting Beneficial Owner (OBO) accounts voted (representing 34 percent of shares held by these accounts) while 15 percent of Non-Objecting Beneficial Owner (NOBO) accounts voted (representing 25 percent of shares held in these accounts.)[215] This contrasts with institutional voting rates that typically exceed 90 percent. The lack of voting participation by retail investors (or by brokers on their behalf) is important to corporate issuers and to voting results because retail investors have traditionally cast their votes disproportionately in support of management on shareholder voting matters when compared to major institutional investors.

The Impact of E-Proxy on Retail Voting Participation. Retail voting participation has fallen sharply in recent years at least in part due to new regulations adopted by the SEC permitting the electronic delivery of proxy materials, including through a "notice and access" process that allows issuers to send shareholders only a notice describing the availability of proxy materials on the Internet. The SEC adopted these "e-proxy" rules in 2007 and they were first utilized by a significant number of companies in 2008. By the 2010 proxy season, more than 1,500 companies were utilizing "notice and access" proxy delivery.[216]

While the new rules led to large documented savings in proxy distribution costs for companies, they also brought a dramatic decline in retail investor voting at accounts who received the notice-only proxy delivery option. John White, former Director of the SEC's Division of Corporate Finance, noted in August 2008 that during the 2008 proxy season, the 653 issuers who used the "notice and access" process experienced a 73 percent drop in the number of retail accounts voting and a 52 percent drop in retail shares voted.[217]

More reeent data provided by Broadridge shows that for the 11-month period from July 1, 2008 through May 31, 2009, among issuers who used a "mixed-option" method – using "notice and access" delivery for some retail accounts and "full-set" delivery for others – the percentage of retail accounts that voted when receiving notice-only was only 4.1 percent, compared with 21.4 percent for retail accounts that received "full-set" delivery of proxy materials.[218] The drop in the actual percentage of retail shares voted was less, with 13.5 percent of shares voted by notice-only retail investors versus 28.6 percent during the same period by "full-set" investors – meaning that the retail investors with the largest holdings under either delivery option were more likely to vote.

The SEC has indicated concern about the drop in retail voting and, in March 2010, it adopted amendments to its rules regarding the Internet availability of proxy materials. The new rules are designed to provide additional flexibility to issuers regarding the format of shareholder notices and to allow issuers to include explanatory materials in shareholder communications under the "notice and access" delivery system.[219] The Commission also expanded its Office of Investor Education and Advocacy and greatly expanded the portion of its Investor.gov website dedicated to providing information related to proxy voting with an eye toward making it easier for retail investors to understand how to vote.

Initiatives to Promote Client-Directed Voting. At the same time that SEC rules for e-proxy were curtailing voting by retail investors, other developments were occurring aimed at restoring the voting power of retail investors. Perhaps the most prominent of these was a campaign to get the SEC to approve and to facilitate the development of client-directed voting, or CDV.

The term "client-directed voting" is generally attributed to Stephen P. Norman, Corporate Secretary at American Express Company, who proposed it as a way to bolster retail voting participation in the wake of the NYSE's 2006 decision to propose the elimination of discretionary broker voting in director elections. In December 2006, Norman made a presentation advocating CDV at a conference. His proposal called for allowing retail investors to inform brokers of their predetermined proxy voting instructions, which the brokers would then execute in cases where the investor did not return a proxy vote. These voting instructions would be set at the time of the original agreement between the broker and the investor, but the investor would retain the right to change or override the pre-determined instruction. Norman's CDV proposal would allow, but not require, an investor to provide an instruction to their broker to vote in a limited number of ways, including:

- vote in accordance with the board's recommendation;
- vote against the board's recommendation;
- abstain from voting; or
- vote proportionately with the broker's instructed votes from other retail investors on the same issue.[220]

This concept of CDV was quickly endorsed by the Society of Corporate Secretaries & Governance Professionals, who said in a comment letter to the NYSE that it would "encourage re-engagement of that segment of retail owners who are currently not voting, or rarely voting" and "provide privacy for those investors who seek it, while ensuring a fair vote, the certainty of a quorum, and the satisfactory conclusion of business at annual meetings."[221]

At the same time, however, critics of the limited set of voting options under this version of CDV proposed a more expansive view of how it should work. "It is possible to conceive of a much more robust model for CDV in which retail investors would have access to a variety of meaningful choices for directed voting," wrote John Wilcox, Chairman of Sodali and an independent consultant on corporate governance to TIAA-CREF. "To be meaningful, CDV should provide [beneficial owners] an array of voting analyses and choices from different types of institutional investors and other groups, including public pension funds,

environmental and social investors, long term centrists such as TIAA-CREF, labor unions, advocacy investors, etc.," Wilcox said.[222] Moreover, in the absence of greater voting options, customization and accountability mechanisms, Wilcox said, CDV could be criticized as a "'dumbing-down' exercise or a thinly disguised alternative to broker discretionary voting, which is no longer permitted."[223]

Similar objections to a narrow interpretation of CDV have been voiced by Mark Latham and James McRitchie. Latham, a founder of votermedia.org, has championed the idea that individual investors could raise both their voting participation and the quality of their decisions by using the Internet to copy the voting decisions of institutional investors or professional proxy advisors. He has also advocated a system where issuers would be required to make funds available to professional proxy advisors, who were chosen by shareholders, to make their voting recommendations available to all shareholders.[224] McRitchie, the publisher of an on-line corporate governance website, calls for "open CDV systems" that would allow shareholders "to informally build individualized proxy voting policies, much like formal policies maintained by institutional investors."[225] Many third-party voting platforms or "feeds" could be created around specific issues of interest to retail investors, who could choose to follow voting advice based on their specific policy concerns or their affiliation with various "brands" that were consistent with their own values.

Early on-line versions of affinity-based CDV voting tools and information that allow investors to piggy-back on the vote recommendations and knowledge of others are already in operation. Two examples of these systems are MoxyVote and ProxyDemocracy. MoxyVote is a free website that allows investors to see upcoming annual meeting ballots and the intended votes of a variety of different advocacy and investor groups. The site is an affiliate of TFS Capital, a registered investment advisor with more than $1 billion in hedge fund and mutual fund assets under management.[226] ProxyDemocracy is a non-profit, foundation-supported organization that provides free on-line tools and information that allow investors to see how institutional investors that publicize their voting intentions in advance of meetings intend to vote. It also provides a ranking system designed to track the extent to which mutual fund families support activist positions in their proxy voting patterns.[227]

The SEC has indicated that it is studying CDV – which it has re-labeled "advance voting instructions" – as part of its review of the U.S. proxy system. Client-directed voting and similar developments aimed at retail investors have the potential to lessen the overall influence of proxy advisory firms, both by diluting the present disproportionate impact of institutional proxy votes and by making it easier for entities to provide voting policies or recommendations that could be readily and widely utilized by others. At the same time, however, the CDV model, if implemented in certain ways, could potentially increase the influence of proxy advisors. This could be the case, for instance, if the voting recommendations of existing proxy advisory firms became the most prominent or widely used voting options for retail investors on CDV voting sites.

IX. The Center On Executive Compensation's Recommendations for Reform of the Proxy Advisory Industry

The Center On Executive Compensation believes that the most effective approach for mitigating and addressing the issues surrounding conflicts of interest, lack of transparency, inaccuracies in reporting and lack of competition in the industry will require a series of regulatory and market reforms. On the regulatory side, the Center recommends the following reforms:

1. **Ban on Worst Form of Conflicts.** The most serious issue facing the proxy advisory firm industry is at the largest proxy advisory firm, ISS, which provides consulting services to corporate issuers while simultaneously providing "independent" analyses to institutional investors on those same companies. This approach creates a vicious cycle in which companies may feel an obligation to patronize ISS for its consulting services in order to obtain favorable proxy voting recommendations on their proposals.

   The Center believes that it would be impossible for a proxy advisory firm to provide both of these services and still meet their fiduciary obligations to the institutional investors. For this reason, the SEC should ban proxy advisory firms, or their affiliates, from providing advisory services to institutional investors, while at the same time providing consulting services to corporate issuers on the matters of proxy votes. Until the change is effective, the SEC should mandate disclosure of the fees paid and services obtained from proxy advisors in the proxy statement, similar to the disclosures currently required for compensation consultants.

2. **Full Disclosure of Other Conflicts.** The SEC should mandate disclosures designed to make the financial relationships that underpin the most controversial aspects of the proxy advisory industry transparent to investors. Specifically, the Center recommends that the SEC should require proxy advisory firms to disclose, in any report containing voting recommendations about a specific issuer, whether the firm has received consulting fees from either the issuer, or the proponent of a shareholder resolution on the ballot at that issuer, in the previous year and the amount of those fees. This disclosure should be located where it is easily assessable to any

investor who is relying on the recommendation in the report. This should be in tabular format to allow ease in identifying potential conflicts of interest.

3. **Disclosure of Methodologies Behind Voting Recommendations.** The SEC should mandate that proxy advisory firms disclose the analytic processes, methodologies and models utilized to derive their voting recommendations. For instance, proxy advisory firms that utilize pay-for-performance compensation models to determine recommendations on compensation plans or advisory say on pay votes should be required to publicly disclose all inputs, formulas, weightings and methodologies used in these models. Such disclosure would allow issuers and investors to effectively assess the merits and weaknesses of such models and to provide feedback to proxy advisory firms on these models.

4. **Clarification of Fiduciary Duties of Institutional Investors and Plan Sponsors.** The SEC should provide additional guidance to investment advisers and plan sponsors making it clear that their fiduciary obligations to vote proxies in the interests of investors require diligent monitoring of the conflicts, practices and competence of third-party proxy advisors. The mere act of hiring a proxy advisor should not be sufficient to allow institutions to meet their fiduciary obligations. Moreover, these obligations should be vigorously enforced to provide a true incentive for institutions to take seriously their role in monitoring and influencing proxy advisory firm behaviors and policies.

5. **Implement SEC Monitoring of Proxy Firm Recommendations** The SEC should implement periodic reviews of proxy firm research reports to check for accurately and completeness, much the way the SEC currently does for company filings. SEC review would be an effective means to educate proxy advisors regarding the SEC's expectations regarding the proxy firms' exercise of due care in issuing reports. It would also help educate the SEC as to the role proxy advisory firms play in the proxy process.

In addition to recommending these regulatory reforms, the Center believes that private sector corporations and institutions should support measures designed to bring additional competition into the proxy advisory industry and to promote greater voting participation by retail investors.

XI. Endnotes

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> ***No.*** Issuers who are ICS clients may not disclose publicly or to an ISS analyst that they have acquired products or services from ICS, per their contract with ICS. ISS does not give preferential treatment to, and is under no obligation to support, any proxy proposal of an issuer whether or not that issuer has purchased products or services from ICS. We request that in any communication you may have with ISS analysts, you do not disclose your identity as an ICS client or potential client, in order to protect the integrity of our research process.

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[161] Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).
[162] Sec. Exch. Comm'n, *supra* note 116, at 110.
[163] *Id.*
[164] *See* Sec. Exch. Comm'n vs. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963).
[165] Sec. Exch. Comm'n, *supra* note 116, at 119.
[166] National Securities Markets Improvements Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).
[167] Investment Advisers Act of 1940 § 203A-2, 15 U.S.C. § 80b-3a(a).
[168] Despite being registered, Proxy Governance ceased providing proxy voting and advisory services at the end of 2010. Accordingly, only two proxy advisory firms remain that are registered as investment advisers with the SEC. Proxy Governance entered into an agreement with Glass Lewis to assume their customer contracts. Glass Lewis is not a registered with the SEC. *See* Press Release, *supro* note 92.
[169] Investment Advisers Act of 1940 § 206-2, 15 U.S.C. § 80b-6(2).
[170] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 12.
[171] *Id.*
[172] *Id.*
[173] Gibson, Dunn & Crutcher, LLP, *supra* note 33.
[174] *Id.*
[175] Sec. Exch. Comm'n, *supra* note 116, at 108-09.
[176] *Id.* at 110.

[177] Strine, Jr., *supra* note 38, at 11.
[178] Belinfanti, *supra* note 1, at 40.
[179] Dep't of Labor, Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. § 2510).
[180] Proposed 29 C.F.R. § 2510.3-21(c)(1)(ii)(C).
[181] Dep't of Labor, *supra* note 179, at 65,266.
[182] The Department of Labor has requested comments from interested parties regarding the proposed regulations. The due date for comments is January 20, 2011. The regulations will not become effective until 180 days after the publication of the final regulation in the Federal Register.
[183] Press Release, The Int'l Org. of Sec. Comm'ns, Global Securities Regulators Adopt New Principles and Increase Focus on Systemic Risk 9 (June 10, 2010).
[184] Press Release, *supra* note 34.
[185] *Id.*
[186] Belinfanti, *supra* note 1, at 54.
[187] *Id.* at 53-54.
[188] Nat'l Investor Relations Inst. and Soc'y of Corporate Sec'ys & Governance Prof'ls, *Proxy Advisory Services: The Need for More Regulatory Oversight and Transparency* (Discussion Draft, Mar. 4, 2010).
[189] Comment letter from Tom Quaadman, Executive Dir. Fin. Reporting & Inv. Opportunity, Ctr. for Capital Markets Competitiveness, to Mary Schapiro, Sec'y, Sec. Exch. Comm'n 3 (Aug. 5, 2010).
[190] *Id.* at 4.
[191] *Id.*
[192] *Id.*
[193] Thompson-Mann, *supra* note 10, at 18.
[194] *Id.*
[195] Paul Rose, *The Corporate Governance Industry*, J. CORP. L. 138 (Summer 2007) (citation omitted).
[196] Center On Executive Compensation, *supra* note 159, at 4.
[197] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 12.
[198] *See* Gibson, Dunn & Crutcher, LLP, *supra* note 33.
[199] Rose, *supra* note 195, at 13.
[200] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 13.
[201] *Id.* at 15.
[202] *Id.* at 13.
[203] Belinfanti, *supra* note 1, at 28.
[204] *Id.* at 30.
[205] Letter from Michael Ryan, Jr., President & Chief Operating Officer, Proxy Governance, to Meagan Thompson-Mann, Millstein Inst. for Corporate Governance & Performance 7 (July 23, 2008), *available at* https://www.proxygovernance.com/content/pgi/img/2008MillsteinResponse.pdf.
[206] Press Release, *supra* note 92.
[207] *Id.*
[208] U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 14-15.
[209] Comment letter from Troutman Sanders, LLP, to Jonathan G. Katz, Sec'y, Sec. Exch. Comm'n (Nov. 22, 2002).
[210] Sec. Exch. Comm'n, *supra* note 116, at 124.
[211] Comment letter from Michael Ryan, Jr., President & Chief Operating Officer, Proxy Governance, to Elisabeth M. Murphy, Fed. Advisory Comm. Mgmt. Officer, Sec. Exch. Comm'n (June 25, 2010).
[212] *Id.*
[213] Press Release, *supra* note 92.
[214] Stephen M. Bainbridge, *Remarks on Say on Pay: An Unjustified Incursion on Director Authority* 10 (UCLA Sch.L., Law & Economics Research Paper Series, Research Paper No. 08-06, March 4, 2008).
[215] Sec. Indus. and Fin. Markets Ass'n, *Report on the Shareholder Communications Process with Street Name Holders, and the NOBO-OBO Mechanism* 20 (Sec. Indus. & Fin. Markets Ass'n. Proxy Working Group, June 10, 2010).

[216] BROADRIDGE INVESTOR COMMUNICATION SOLUTIONS, *supra* note 14.
[217] John W. White, Dir., Division of Corp. Fin., Sec. Exch. Comm'n, Address before the Amer. Bar. Ass'n, *Corporate Finance – A Year of Progress*, (Aug. 11, 2008).
[218] Sec. Exch. Comm'n, Amendments to Rules Requiring Internet Availability of Proxy Materials, Release Nos. 33-9073; 34-60825, at 7 (Oct. 14, 2009).
[219] Sec. Exch. Comm'n, Final Rule: Amendments to Rules Requiring Internet Availability of Proxy Materials, Exchange Act Release Nos. 33-9108, 34-61560, 17 C.F.R. §§ 230, 240 (Mar. 29, 2010).
[220] NYSE Proxy Working Group, *August 27, 2007 Addendum to Report and Recommendotion of the Proxy Working Group to the New York Stock Exchange Dated June 5, 2006* 5 (Aug. 27, 2007).
[221] Comment letter from David W. Smith, Soc'y of Corporate Sec'ys & Governance Prof'ls to Catherine Kinney, President and Co-Chief Operating Officer, New York Stock Exchange Group (Dec. 14, 2006).
[222] John Wilcox, *Fixing the Problems with Client Directed Voting*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, March 5, 2010, http://blogs.law.harvard.edu/corpgov/2010/03/05/fixing-the-problems-with-client-directed-voting/.
[223] *Id.*
[224] *See* Mark Latham, *The Internet Will Drive Corporate Monitoring*, CORPORATE GOVERNANCE INT'L (June 2000); Mark Latham, *Proxy Voting Brand Competition*, 5 J. INV. MGMT. 79-90 (2007).
[225] Comment letter from James McRitchie, Publisher, Corporate Governance Int'l, to Elisabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (July 16, 2010).
[226] *See* Moxy Vote, http://www.moxyvote.com.
[227] *See* Proxy Democracy, http://www.proxydemocracy.org.

Statement of Niels Holch
Executive Director
Shareholder Communications Coalition

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
U.S. House of Representatives

Hearing on "Examining the Market Power and Impact of Proxy Advisory Firms"

June 5, 2013

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee, my name is Niels Holch, and I am the Executive Director of the Shareholder Communications Coalition.

The Shareholder Communications Coalition (www.shareholdercoalition.com) comprises three professional associations representing the interests of public companies: Business Roundtable, the Society of Corporate Secretaries & Governance Professionals, and the National Investor Relations Institute.

The Shareholder Communications Coalition was established in 2005, after Business Roundtable filed a Petition for Rulemaking with the Securities and Exchange Commission ("SEC") in 2004, urging the agency to conduct a comprehensive evaluation of the shareholder communications and proxy voting system.

Many of the current SEC rules governing this system were adopted in 1985, more than 25 years ago. These SEC rules were promulgated during a period when most annual meetings were routine, and few matters were contested. These rules also were developed at a time when technology and electronic communications were not nearly as sophisticated as they are today.

It was not until six (6) years after the Business Roundtable Petition for Rulemaking was filed that the SEC undertook an evaluation of the shareholder communications and proxy voting system, and, in July 2010, released for public comment a Concept Release on the U.S. Proxy System.

In its Concept Release, the SEC acknowledged that the time had come to review various aspects of the U.S. proxy system. The Concept Release outlined concerns that have been raised regarding the accuracy, reliability, transparency, accountability, and integrity of the current proxy system. The Concept Release also discussed possible regulatory solutions to the many problems that have been identified, including those related to shareholder communications, proxy distribution and voting, and proxy advisory services.

The SEC received more than 300 comment letters in response to this Concept Release, the substantial majority of which expressed the view that reforms to the existing system are necessary.

Unfortunately, another three (3) years has passed and the SEC has not initiated any rulemakings to follow-up on the Concept Release and address the many identified problems in the current shareholder communications and proxy voting system.

While we acknowledge the SEC's heavy workload under the Dodd-Frank and JOBS Acts, the Coalition believes strongly that there should not be any further delays—it is now time for the SEC to address the concerns identified in the Concept Release.

As the SEC itself noted in its Concept Release: "[w]ith 600 billion shares voted every year at more than 13,000 shareholder meetings, shareholders should be served by a well-functioning proxy system that promotes efficient and accurate voting."[1]

The Coalition urges the members of this Subcommittee to request that the SEC turn to these issues and promptly initiate a series of rulemakings to reform its shareholder communications and proxy rules.

The Current Proxy System

In order to promote an understanding of the problems in this area, let me explain in greater detail how the current proxy system works, and why the Coalition believes reforms are necessary.

It is estimated that 75-80% of all public company shares in the United States are held in "street name," meaning in the name of a broker or a bank that holds the shares on behalf of its clients and customers, who are called the "beneficial owners." When shares are purchased in street name, the underlying beneficial owners of the shares are not registered on the books and records of a public company.

The street name system of stock ownership expanded after the Wall Street paperwork crisis in the 1970's. The primary purpose of this system was—and still is today—to enable securities transactions to be processed and cleared in an efficient manner.

Under SEC and stock exchange rules, brokers and banks are responsible for distributing annual meeting materials provided by companies (and requesting voting

[1] Concept Release on the U.S. Proxy System, 75 Fed. Reg. 42,982, at 42,983 (July 22, 2010).

instructions) from beneficial owners who are holding their shares in street name. Since many shareholders do not attend annual meetings in person, companies need to solicit votes through a proxy system that functions in a similar fashion to the absentee balloting process used in federal and state elections.

The U.S. proxy system is complicated and multi-faceted, involving several layers of intermediaries who are not the economic owners of corporate shares. This intermediation in the proxy process increases the complexity and the cost of processing proxy materials and tabulating votes. It also makes it very difficult for companies to know who their shareholders are and to communicate with them in an effective manner.

The proxy system and the SEC's rules have also not kept pace with the development of back office systems used in the securities industry, significant advances in the use and availability of communication technologies, and the growth of the Internet.

Similarly, corporate governance practices have changed significantly since the 1980's, when many of the SEC rules governing the proxy system were put in place. There has been a substantial move away from plurality voting in favor of majority voting for uncontested director elections. Shareholder proposals are on the increase, as is voting support for them. The Dodd-Frank Act now requires companies to provide a regular "say on pay" advisory vote for their shareholders. And recent changes to New York Stock Exchange rules have limited broker discretionary voting.

These changes have accelerated the need for companies to communicate more frequently, and on a more time-sensitive basis, with their shareholders. However, this is difficult to accomplish under the current proxy system, which is controlled by brokers and banks, and which classifies beneficial owners as either Objecting Beneficial Owners

("OBOs") or Non-Objecting Beneficial Owners ("NOBOs"). Public companies are not permitted to communicate directly with OBOs; and communication with NOBOs is expensive and restricted with respect to the distribution of proxy materials.

As you will see from this testimony, the public companies represented by the Coalition have one overriding goal in this area: *they want to know who their shareholders are, and they want to be able to communicate directly with them.*

Public Company Concerns with the Current Proxy Communication and Voting System

Public companies are understandably frustrated by a shareholder communications system that prevents them from knowing who many of their shareholders are and effectively communicating with them. Under the current structure, companies seeking to encourage more voting participation by beneficial owners, and engage in dialogue with them, cannot do so without using a complicated, circuitous, and expensive process that is largely outside their control.

The Need for Direct Shareholder Communications

Public companies want to have direct communications with their shareholders. The NOBO/OBO system impedes communications between shareholders and the companies they are invested in. Survey research has demonstrated that individual investors are confused by this classification system. In an age of instant communications and heightened shareholder empowerment, there is no reason to have this type of barrier to open and direct communications between a public company and its beneficial owners.

For these reasons, the Coalition supports the elimination of the NOBO/OBO classification system. This reform would ensure that public companies could have access to contact information and share position for their beneficial owners and would be permitted to communicate with them directly.

This reform would also bring the U.S. system in line with the capital market practices of other countries, where companies are entitled to receive information regarding the identities of their beneficial owners. As an example, the United Kingdom requires full transparency regarding the identity of individuals and institutions holding voting rights and/or beneficial owner interests, with civil and criminal penalties for a failure to make appropriate disclosures to public companies.[2]

Once public companies have access to information about their shareholders, they could assume the responsibility of distributing proxy materials directly to their shareholders, thereby facilitating direct communications with them.

Some investors—both individual and institutional—may want to retain their anonymity, either for trading purposes or for proxy voting purposes, or both, and we anticipate that the system could provide for that. For example, those investors who wish to remain anonymous could be permitted to establish nominee accounts, or otherwise use custodial arrangements to maintain their anonymity. Nominee status and custodial arrangements are common methods for institutional investors to hold their shares anonymously, and these methods should not change under the proposed reform.

Obviously, before any change is made to the NOBO/OBO system, there should be adequate notice to all investors, so that they have sufficient time to consider their options.

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[2] See Sections 793-795 of the UK Companies Act 2006.

Other stakeholders in the proxy process have expressed similar concerns about the barriers to communicating with beneficial owners in the street name system. For example, the Council of Institutional Investors commissioned a study on the proxy processing system, which was released in February of 2010.[3] The study was critical of the NOBO/OBO system and supportive of measures to increase the potential of direct communications between companies and their shareholders.[4]

The Need for an Improved Proxy Voting System

Other concerns have been raised about the mechanics of the current proxy voting system, which needs to be improved to ensure that vote counts are accurate, verifiable, and auditable.

Reports in the news media of voting miscounts and delays in determining election results by proxy service providers have raised questions about the integrity of the proxy voting process. Additionally, there is no ability for an independent third-party to audit and verify the results of a close election.

These proxy voting issues need to be addressed, as increased investor activism will certainly cause many more close votes on shareholder proposals, director elections, and other matters.

The integrity of the proxy voting process is essential to the proper functioning of our capital markets. Proxy voting should be fully transparent and verifiable, starting with a list of beneficial owners eligible to vote at a shareholder meeting and ending with the final tabulation of votes cast at the shareholder meeting.

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[3] Alan L. Beller and Janet L. Fisher, The OBO/NOBO Distinction in Beneficial Ownership: Implications for Shareowner Communications and Voting (Feb. 18, 2010).

[4] See Letter from Glenn Davis, Senior Research Associate, Council of Institutional Investors, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, SEC File No. S7-14-10 (Oct. 14, 2010).

The vote counts on matters before a shareholder meeting should be auditable and capable of third-party verification, so that a validation of the votes of all shareholders can occur.

Public Company Concerns with Proxy Advisory Firms

Public companies are also concerned about the role and activities of the private firms providing proxy advisory services to institutional investors, which operate today with very little regulation or oversight. The SEC also raised this issue in its 2010 Concept Release.

There is a lack of transparency in the way proxy advisory firms operate, with insufficient information available about their standards, procedures, and methodologies. Conflicts of interest exist in several of their business practices; and concerns exist about their use of incorrect factual information in formulating specific voting recommendations.

These firms have considerable influence in the proxy voting process, as they generate voting recommendations for their clients, and, in fact, make voting decisions for some of their clients. The clients of these firms are institutional investors, including pension plans, mutual funds, hedge funds, and endowments.

Despite their large role in proxy matters, proxy advisory firms develop their policies using a "one-size-fits-all" approach that generally applies the same standards to all public companies, instead of evaluating the specific facts and circumstances of each company they evaluate.

One of the reasons that proxy advisory firms have become so powerful is that many interpret SEC and Department of Labor rules and guidance as requiring

institutional investors to vote all their proxies at shareholder meetings as a part of the fiduciary duties they owe to their clients, investors, and beneficiaries. These regulations and guidance apply to investment companies, investment advisers, and many retirement and pension plans.

Many institutional investors and their third-party investment managers—especially mid-size and smaller firms—choose to reduce costs by not having in-house staff to analyze and vote on proxy items. Instead, these institutional investors and managers typically outsource their voting decisions to proxy advisory firms.

The proxy advisory industry is subject to a regulatory framework that can best be described as a patchwork quilt. As an example, the largest proxy advisory firm, Institutional Shareholder Services ("ISS"), has chosen to register under the Investment Advisers Act of 1940. However, the SEC's rules for investment advisers do not reflect the unique role that these advisory firms perform in the proxy voting process.

The second biggest proxy advisory firm, Glass Lewis, is not registered as an investment adviser and is not currently subject to any regulatory supervision. For example, the SEC just sanctioned ISS under the Investment Advisers Act for failing to establish or enforce written policies and procedures to prevent the misuse of material, non-public information by ISS employees with third parties.[5] As a non-registered entity, Glass Lewis is not subject to a number of provisions of the Investment Advisers Act and the SEC rules implementing the Act.

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[5] See Order Instituting Administrative and Cease-and-Desist Proceedings and Imposing Remedial Sanctions and a Cease-and-Desist Order, In the Matter of Institutional Shareholder Services, Inc., Administrative Proceeding File No. 3-15331, May 23, 2013, available at http://www.sec.gov/litigation/admin/2013/ia-3611.pdf.

Additionally, the SEC has created an exemption from its proxy rules for these firms, so they are not required to abide by solicitation and disclosure rules that apply to other proxy participants. Thus, their reports, in contrast to company proxy materials, are not publicly available, even after annual meetings.

This patchwork system should not be permitted to continue, and these firms should be subject to more robust oversight by the SEC and the institutional investors that rely on them. For example, the current exemption from the proxy rules that proxy advisory firms rely on could be conditioned on their meeting certain minimum requirements governing their activities and conduct. The SEC should also consider a requirement that all proxy advisory firms register under the Investment Advisers Act of 1940, under a targeted regulatory framework that reflects the unique role they perform in the proxy voting process.

As noted earlier, there is a need for greater transparency about the internal procedures, policies, standards, methodologies, and assumptions used by these firms to develop voting recommendations.

And there needs to be attention to the problem of inaccuracies in the reports provided by proxy advisory firms. One firm—ISS—provides drafts (on a very short turnaround) only to S&P 500 companies and the other major proxy advisory firm—Glass Lewis—does not even do that.

All proxy advisory firms should be required to provide each public company with a copy of their draft reports, in advance of dissemination to their clients, to permit a company to review and correct any inaccurate factual information contained in these

reports. Shareholders should not be voting based on inaccurate information in the reports of proxy advisory firms.

Another problem is that Glass Lewis refuses to provide a copy of its final reports to any public company that does not pay to subscribe to its services. And for those who do pay, both firms are attempting to impose unreasonable restrictions on a company's use of the information. It does not seem right that companies should have to pay a proxy advisory firm to find out what their shareholders are being told about the matters being voted on at a shareholder meeting.

Conflicts of interest within these firms also need to be addressed. One proxy advisory firm, for example, provides corporate governance and executive compensation consulting services to public companies, in addition to providing voting recommendations to its institutional clients on proxy matters for these same companies.

Another conflict that exists is proxy advisory firms providing voting recommendations on shareholder proposals submitted to companies by their institutional investor clients.

These conflicts should be specifically disclosed to clients of proxy advisory firms so that they may evaluate this information in the context of the firms' voting recommendations.

Along with considering greater regulatory oversight of proxy advisory firms, the SEC and Department of Labor should review the existing regulatory framework applicable to the use of proxy advisory firms by institutional investors. This review should include the guidance and interpretive letters that have been issued over the years on this subject. The SEC and Department of Labor should ensure that institutional

investors are exercising sufficient oversight over their use of proxy advisory services, in a manner consistent with their fiduciary duties.

Next Steps

As noted earlier, it has been more than 25 years since the SEC's proxy rules have been updated and nine (9) years since the Business Roundtable filed its Petition for Rulemaking with the SEC, urging reform to the shareholder communications and proxy voting system.

The SEC must turn its attention to reforming the proxy system, addressing the issues raised in its 2010 Concept Release. We anticipate it would do so through a series of rulemakings in which it would obtain the input of public companies and other stakeholders in the proxy process.

The Coalition urges the members of this Subcommittee to request SEC action in this area.

Thank you for the opportunity to present the Shareholder Communication Coalition's views on these important issues. At the appropriate time, I am happy to answer any questions that the members of the Subcommittee may have.

Testimony of

Michael McCauley

Senior Officer – Investment Programs & Governance

Florida State Board of Administration (SBA)

before the

Subcommittee on Capital Markets and Government Sponsored Enterprises

of the

United States House of Representatives Committee on Financial Services

Wednesday, June 5, 2013

Examining the Market Power and Impact of Proxy Advisory Firms

Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee:

Good morning. I am Michael McCauley, Senior Officer – Investment Programs and Governance, for the Florida State Board of Administration, or "SBA." I am pleased to appear before you today on behalf of the SBA.

My testimony includes a brief overview of the Florida State Board of Administration and its investment approach, followed by a discussion of our proxy voting process and procedures and our use of proxy advisers to assist the SBA in fulfilling its proxy voting obligations. I will also discuss some proposed reforms that the SBA believes will make proxy advisers more transparent to the market and more accountable to their clients.

Florida State Board of Administration

The Florida State Board of Administration manages more than thirty separate investment mandates and trust funds, some established as direct requirements of Florida law and others developed as client-initiated trust arrangements. In total, the SBA manages approximately $170 billion in assets, providing retirement benefits for more than 1 million current and former employees of Florida state government, public schools, universities and colleges, and many cities and local government districts. One of these funds, the Florida Retirement System Pension Plan ("FRS pension plan"), accounts for approximately 80 percent of the total assets under management. The FRS pension plan provides more than $7.3 billion in annual benefit payments to more than 1

million individuals.[1] The SBA has a long history of successful fund management.[2] Under Florida law the SBA manages the funds under its care according to fiduciary standards similar to those of other public and private pension and retirement plans: The SBA must act in the best interests of the fund beneficiaries. This standard encompasses all activities of the SBA, including the voting of all proxies held in funds under SBA management.

Proxy Voting

Proxy voting is an integral part of managing assets in the best interests of fund clients and beneficiaries. In fiscal year 2012, the Florida State Board of Administration executed votes on thousands of public companies.[3] During the most recent trailing twelve months ended March 31, 2013, the SBA executed votes at 9,534 public companies on 85,408 individual voting items, including director elections, audit firm ratification, executive compensation, and merger approval. Of the 85,408 voting items over the last twelve months ending March 31, 2013, the SBA cast 80 percent "for," 16 percent "against" and 3 percent "withhold." On less than 1 percent of ballot items, the SBA abstained or did not vote.

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[1] "Annual Report, The Florida Retirement System and Other State Administered Systems," July 1, 2010-June 30, 2011, at 41, https://www.rol.frs.state.fl.us/forms/2011-12_Annual_Report.pdf.
[2] "Overview of the State Board of Administration of Florida as of December 31, 2012," http://www.sbafla.com/fsb/LinkClick.aspx?fileticket=gXE1No0N3yI%3d&tabid=997&mid=2293.
[3] "Proxy Voting: Summary Report Fiscal year 2012," State Board of Administration of Florida, at 12, http://www.sbafla.com/fsb/portals/Internet/CorpGov/ReportsPublications/20121031_SBAProxyVotingSummary.pdf.

The SBA makes all proxy voting decisions independently. To ensure that the SBA meets its fiduciary obligations, it established the Corporate Governance & Proxy Voting Oversight Group ("Proxy Committee") as one element in an overall enterprise risk management program. The Proxy Committee is comprised of several SBA staff members including myself, the Deputy Executive Director, the Chief Risk & Compliance Officer, the Co-Senior Investment Officers over Global Equity, and the Director of Investment Risk Management. The Proxy Committee, which met five times in 2012, oversees the SBA's proxy voting process and reviews and approves significant and contested matters regarding corporate governance and voting.

The SBA votes based on written corporate governance principles and proxy voting guidelines it develops internally for common issues expected to be presented for shareowner ratification. The SBA's proxy voting guidelines reflect its belief that good corporate governance practices will best serve and protect the funds' long-term investments, and are reviewed and approved by the SBA's Investment Advisory Council and Board of Trustees on an annual basis.

The SBA's voting policies are developed using empirical research, industry studies, investment surveys, and other general corporate finance literature. SBA voting policies are based both on market experience and balanced academic and industry studies, which aid in the application of specific policy criteria, quantitative thresholds, and other qualitative metrics. For 2012, the SBA issued guidelines for more than 350 typical voting issues and voted at least 80 percent of these issues on a case-by-case basis, following a company-specific assessment. The SBA discloses all proxy voting decisions

once they have been made, normally seven to ten days prior to annual shareowner meetings. Historical proxy votes are also archived for a period of five years and are available electronically on the SBA's website.

To supplement its own proxy voting research, the SBA purchases research and voting advice from several outside firms, principally three leading proxy advisory and corporate governance firms: Glass, Lewis & Co. ("Glass Lewis"), Manifest Information Services LLC ("Manifest"), and MSCI Institutional Shareholder Services ("ISS"). The SBA uses additional external research providers for more narrow and specialized analyses covering executive compensation. Glass Lewis's research covers the entire U.S. stock universe of Russell 3000 companies and virtually all non-U.S. equities. Manifest provides analysis of proxy issues and meeting agendas on a non-advisory basis, with a primary emphasis on European and large capitalization global companies. ISS provides specific analysis of proxy issues and meeting agendas on all publicly traded U.S. and non-U.S. equity securities. Additionally, the SBA executes its global equity votes on ISS's voting platform, ProxyExchange.[4]

When making voting decisions, the SBA considers the research and recommendations provided by Glass Lewis, Manifest and ISS, along with other relevant facts and research, and the SBA's own proxy voting guidelines.[5] But the SBA makes voting decisions independently and in what it considers to be the best interests of the beneficiaries of the funds it manages. Proxy advisor and governance research firm

[4] *Ibid.* at 11.
[5] "Corporate Governance Principles & Proxy Voting Guidelines," State Board of Administration of Florida (2012), http://www.sbafla.com/fsb/LinkClick.aspx?fileticket=KY96Es7W718%3d&tabid=1439&mid=3907.

recommendations inform but do not determine how the State Board of Administration votes. And they do not have a disproportionate effect on SBA voting decisions. In fiscal year 2012, the votes that SBA executed correlated with the recommendations of one firm 67 percent of the time.[6] Other historical reviews of SBA voting correlation have shown both lower and higher correlations with individual external proxy adviser recommendations, depending on both the time period studied and specific voting categories in question. Over the last few years, the SBA has voted with management (the "management-recommended-vote") more than 80 percent of the time across all voted portfolios.

On advisory votes on executive compensation ("say on pay"), perhaps the most closely tracked proxy adviser recommendations, the SBA clearly charted its own path. In 2011, ISS recommended votes against 12.2 percent of management say-on-pay proposals. The SBA tracked ISS's recommendations less than half the time, voting against 25.4 percent of management say-on-pay proposals. Among all SBA 'against' voting decisions in 2011, the SBA vote deviated 51.9 percent of the time when compared to the ISS recommended vote. SBA voting patterns on say-on-pay ballot items, both during fiscal-year 2012 and fiscal-year-to-date 2013, have not been dissimilar.

Recommendations for Reform

While the Florida State Board of Administration acknowledges the valuable role that proxy advisers play in providing pension funds with informative, accurate research on

[6] *Ibid.* at 21

matters that are put before shareowners for a vote, we believe proxy advisory firms should provide clients with substantive rationales for vote recommendations, minimize conflicts of interest and have appropriate oversight. Toward that end, the SBA believes that proxy advisers should register as investment advisers under the Investment Advisers Act of 1940.

Registration would establish important duties and standards of care that proxy advisers must uphold when advising institutional investors. Additionally, the mandatory disclosures would expose conflicts of interest and how they are managed, and establish liability for firms that withhold information about such conflicts. Mandatory disclosures should also include material information regarding the process and methodology by which the firms make their recommendations, aimed at allowing all stakeholders to fully understand how an individual proxy adviser develops voting recommendations. This would make adviser recommendations more valuable to institutional investor clients and more transparent to other market participants. In this way registration would complement the aims of existing securities regulation, which seeks to establish full disclosure of all material information.

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Thank you, Mr. Chairman for inviting me to participate at this hearing. I look forward to the opportunity to respond to any questions.

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WRITTEN TESTIMONY

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President & CEO
National Investor Relations Institute

June 5, 2013

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

Hearing on "Examining the Market Power and Impact of Proxy Advisory Firms"

INTRODUCTION

My name is Jeffrey D. Morgan and I am President and CEO of the National Investor Relations Institute. Founded in 1969, NIRI is the professional association of corporate officers and investor relations consultants responsible for communication among corporate management, shareholders, securities analysts, and other financial community constituents. NIRI is the largest professional investor relations (IR) association in the world with more than 3,300 members representing over 1,600 publicly held companies and over $9 trillion in stock market capitalization.

NIRI appreciates the opportunity to present our views on the regulation of proxy advisory firms and other ways to improve the ability of public companies (also known as "issuers") to communicate with their investors. NIRI thanks Chairman Scott Garrett, Ranking Member Carolyn Maloney, and the Subcommittee's staff for scheduling this hearing on these important issues.

BACKGROUND

NIRI supports transparent, fair, efficient, and robust capital markets, which are essential to promoting innovation, sustainable job creation, and a strong U.S. economy. Vital to such capital markets are ensuring that public companies can communicate effectively with their shareholders and that investors receive accurate information. We need to have an accurate and transparent proxy system that allows efficient two-way corporate-investor communications and ensures equality among shareholders.

Shareholders are the ultimate owners of our public companies and they must have accurate and timely information so they can make informed decisions when they buy or sell a company's shares or cast their ballots at shareholder meetings. IR professionals play a dual role in this important two-way communication process. They work to ensure that all investors have fair access to the publicly available and material information about a company's financial results, future prospects, and corporate governance. IR professionals also make sure that shareholders' views are heard by management and directors.

My testimony will focus on two concerns that relate to the ability of companies to reach their investors: 1) the role of loosely regulated proxy advisory firms and 2) the outdated SEC rules that can prevent companies from effectively communicating with shareholders on a timely basis. NIRI has a long record of seeking reforms on these two issues. NIRI has submitted and also joined other organizations in submitting various comment letters to the SEC on ways to reform the archaic and complex proxy communications system – an outdated system that has not kept pace with globalization, technological innovation, and in general, more modern times.

THE GROWING INFLUENCE OF PROXY ADVISORY FIRMS

Before outlining our suggested reforms on proxy advisory firms, it may be helpful to review how these firms became so powerful. Over the past 25 years, there has been a fundamental shift in who owns shares in U.S. public companies. In 1987, mutual funds, pension funds, and other

institutional investors owned 47 percent of the shares of the largest 1,000 U.S. companies. By 2007, these institutions had increased their ownership to 76 percent.[1] Consequently, these institutions and their proxy advisors now exercise tremendous influence when companies hold their annual meetings each year to seek investor support on director candidates, executive compensation, potential takeover offers, and other material matters.

Unlike many individual investors who vote sporadically at annual meetings, mutual fund and pension fund managers are required to vote all their shares on every matter, a result of various interpretations by the SEC and the Department of Labor. For the largest institutions, that means that they must vote on more than 100,000 ballot items each year. More than 80 percent of U.S. companies hold their annual meetings each spring, which further intensifies the voting workload for institutional investors. In order to manage the costly and time-consuming responsibility of voting all these ballots, many institutions and their investment managers commonly outsource this responsibility to a proxy advisory firm. In a 2004 comment letter, the SEC further encouraged this practice when it noted that investment managers avoid potential conflicts of interest if they followed the advice of an outside proxy advisor.[2] Should they decide to override their proxy advisor, some institutions require an extra level of documentation to support the investment manager's decision, which can later become a key factor in that firm's ability to attract capital from large pension funds and endowments that look to understand each time an investment manager diverges from a proxy advisor's recommendation.

Today, two firms, Institutional Shareholder Services (ISS) and Glass Lewis & Co., dominate the proxy advisory business. While there are varying estimates of their influence, it has been estimated that ISS has a 61 percent market share, while Glass Lewis has a 36 percent share.[3] According to a 2007 General Accounting Office study, the two firms collectively had more than 2,000 institutional clients with $40.5 trillion in assets.[4]

Today, proxy advisory firms remain largely unregulated and unsupervised, while substantial concerns have been raised by companies and academics about: (1) a lack of transparency concerning their standards, procedures, and methodologies; (2) the risk that their voting

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[1] "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15-16, available at: http://www.executivecompensation.org/docs/c11-07b%20Proxy%20Advisory%20White%20Paper.pdf

[2] "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, available at: http://www.sec.gov/divisions/investment/noaction/egan052704.htm

[3] Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business & Finance* 14 (Spring 2009): 395. The author, an associate professor at New York Law School, attached the comment to a letter filed with the SEC on Oct. 20, 2010. That letter is available at: http://www.sec.gov/comments/s7-14-10/s71410-183.pdf

[4] *See* Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, a Report to Congressional Requesters*, GAO-07-765 (Washington, June 2007): 13, http://www.gao.gov/new.items/d07765.pdf

recommendations may be based on incorrect factual information; and (3) the inherent conflicts of interest posed by several of their business practices.

Given their large roster of clients, the two largest advisory firms can have extraordinary influence on the outcome of director elections and other proxy voting matters. Collectively, ISS and Glass Lewis clients may own between 20 and 50 percent of a large or mid-cap company's shares. While not all institutions follow the advice of their proxy advisors in all cases, many of them do so, particularly the small and medium-size institutions that don't have their own corporate governance staffs. Although the influence of the proxy advisors varies by company and subject matter, governance experts have found that a negative proxy advisor recommendation can lead to a 15 to 30 percentage point differential in support for management. As Leo E. Strine Jr., vice chancellor of the Delaware Court of Chancery, has observed: "Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS having a large sway in the affairs of American corporations."[5]

The influence of ISS and Glass Lewis has increased again when the Dodd-Frank Wall Street Reform and Consumer Protection Act required U.S. companies to hold shareholder "Say on Pay" votes on their executive compensation practices. In 2012, companies receiving a negative recommendation from ISS on executive pay saw their average support levels fall from 94 to 64 percent, according to Semler Brossy, an executive compensation consultant.[6]

Unlike investors and companies whose proxy filings are subject to review and sanctions by the SEC, proxy advisors generally are exempt from regulation. Although ISS has registered with the SEC as a registered investment advisor, the SEC does not provide systematic oversight over the proxy firms' policies and research processes, how the firms interact with companies, and how they communicate with investors and other market participants. In its 2010 concept release on the U.S. proxy voting system, the SEC acknowledged the significant role of proxy advisors, but the Commission has not yet taken any formal action to address their research practices.[7] While Commission officials indicated in June 2012 that they were working on this, it does not appear

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[5] Leo E. Strine Jr., "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face," *Delaware Journal of Corporate Law* 30 (2005): 688, available at: http://ssrn.com/abstract=893940 *See also* "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15–16, available at: http://www.executivecompensation.org/docs/c11-07b%20Proxy%20Advisory%20White%20Paper.pdf

[6] *See* Semler Brossy, "2012 Say on Pay Results: Year-End Report" (Dec. 31, 2012) (this report analyzed vote results from the Russell 3000 companies that held pay votes in 2012), available at: http://www.semlerbrossy.com/wp-content/uploads/2013/01/SBCG-SOP-Year-End-Report.pdf

[7] On May 23, 2013, the SEC announced a settlement with ISS over the firm's failure to adequately safeguard confidential proxy voting information from more than 100 clients. That case resulted from a whistleblower's complaint that alleged that an ISS employee accepted meals, tickets for concerts and sports events, and other benefits from a proxy solicitor in exchange for the confidential information. Without the whistleblower, it is unlikely that the SEC would have uncovered this wrongdoing on its own. While this case did not involve ISS research analysts, it does illustrate that more robust regulation is needed and raises questions about the ability of ISS to manage its conflicts of interest. *See* "SEC Charges Institutional Shareholder Services in Breach of Clients' Confidential Proxy Voting Information" (May 23, 2013), available at: http://www.sec.gov/news/press/2013/2013-92.htm

that this issue is as high a priority as other agency initiatives, including various mandates under the Dodd-Frank Act and the JOBS Act, and resources appear to have been allocated accordingly thus far.[8]

Lack of Transparency and Opportunities for Corporate Input

Proxy advisory firms play a major role in shaping how institutional investors view corporate governance issues, but the advisors' policy development process and methodologies are largely opaque, with limited opportunities for corporate input. In some cases, proxy advisory firms work with their clients to develop unique voting guidelines. However, more often than not, investors accept benchmark voting guidelines policies developed by the proxy advisory firms. While some clients provide input on particular voting policies, the reality is often that the proxy advisory firm suggests the policy; and voting patterns at companies suggest that many institutions vote according to those policies. The end result of this process is not a unique set of voting instructions for each institutional client, but a set of guidelines and policies that have been developed by the proxy advisory firm and are used by most of the firm's clients. As a general matter, the proxy firms do not evaluate the facts and circumstances of each public company with respect to the matters to be voted on; instead, their voting guidelines encourage a procrustean "one-size-fits-all" or "check the box" methodology.

Since the global economic crisis of 2008-09, we believe that proxy advisors have faced increasing pressure from their investor clients to constrain costs. This pressure has further encouraged the proxy advisors to adopt "one-size-fits-all" voting policies that are less costly to apply. We also believe that proxy advisors have responded by cutting their full-time research staffs, hiring temporary employees who have little training in U.S. corporate governance, and shifting work to low-cost labor locations outside the United States.

While ISS and Glass Lewis have responded to corporate complaints and released more details on their policies in recent years, these firms do not fully disclose, as one example, all the methodologies that they use to develop their vote recommendations, including their evaluation of a company's equity incentives or other pay practices.

While ISS now provides a brief comment period (typically less than a month) each fall for issuers to weigh in on selected policy updates, ISS rarely makes significant policy changes in response to corporate input. The proxy advisors could do much more to ensure that their policies and research methodologies are fully transparent. They should also disclose the academic research, if any exists, that demonstrates that their voting policies generate long-term shareholder value.[9] Finally, proxy advisors should be required to publicly file their reports with the SEC, so companies and investors can better judge the value of the advice provided.

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[8] The SEC has designated an official in its Division of Corporation Finance to receive corporate complaints about proxy advisors, but the agency has not publicly disclosed details on those complaints or any official action taken by Commission staff.

[9] Researchers at Stanford University have found that there is a negative correlation between the proxy firms' compensation policies and shareholder value. *See* David F. Larcker et al., "Outsourcing Shareholder Voting to Proxy Advisory Firms" (working paper, Rock Center for Corporate Governance at Stanford University, May 10, 2013),

Most Companies Have No Chance to Review Advisors' Reports for Accuracy

One of the most serious concerns with current proxy advisor policies is that most companies have no or very limited opportunity to review the advisors' reports on their annual meetings before investors cast votes based on those recommendations. This increases the risk that the advisory firms will make recommendations that are based on inaccurate factual information. This is especially a concern in the area of executive compensation, where pay arrangements are complex and the advisors use different methodologies for calculating the value of certain incentive arrangements. These errors are not surprising given the large volume of proxy statements each spring that are reviewed by the advisors' research teams, who have limited training, work long hours during proxy season, and include temporary and overseas employees. If a company spots an error and contacts the proxy advisor to complain, the proxy advisor may send an "alert" to its clients, but those alerts may arrive too late. Given their heavy proxy season workloads each spring, many institutional investors vote their shares immediately after receiving their proxy advisor's recommendation and some will not bother to change their vote if an alert is issued.

So far, ISS and Glass Lewis have resisted requests to allow all companies an opportunity to review their reports for accuracy before they are released to investors. As a result, many companies are blind-sided by negative recommendations and have limited time to correct that information and make their case to their investors, many of whom have already voted. In response to corporate concerns, ISS does provide a limited opportunity (i.e., 24 to 48 hours) for S&P 500 firms to review a draft copy of their reports. This review process is quite helpful for these large-cap companies because they may spot inaccurate factual information, or notice an improper application of ISS policies to the company's specific circumstances. In addition, a company may be able to easily address the concerns (e.g., by adopting a new board policy on severance pay or providing more disclosure) that led to the negative ISS recommendation. Institutional investors also benefit from this review process because they receive reports that are more accurate and complete and have to change their votes less frequently. Regrettably, ISS has declined to offer this necessary safeguard to mid-cap and smaller companies, which typically are less familiar with proxy advisor policies and could equally benefit from this review process. ISS also has restricted the ability of companies to share final ISS reports with their outside lawyers, pay consultants, or proxy solicitors, a practice that has further hindered the ability of companies to identify inaccuracies and respond quickly. Glass Lewis has declined to make its drafts available to any U.S. company.

In light of the significant role that proxy advisors play in U.S. corporate governance, the SEC should act to ensure that companies have a reasonable opportunity to ensure that their investors receive accurate information.

Inherent Conflicts of Interest

The inherent conflicts of interest posed by the proxy advisors' business practices also need to be addressed by regulators. In addition to assessing corporate disclosure practices and delivering

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available at: http://www.niri.org/Other-Content/sampledocs/David-Larcker-Stanford-University-et-al-Outsourcing-Shareholder-Voting-to-Proxy-Advisory-Firms.aspx

voting recommendations to investors, ISS sells corporate governance consulting and executive compensation data to companies. For example, ISS offers a consulting service to help companies determine if their equity plans meet ISS' approval criteria; and it provides a service to evaluate "corporate sustainability," which involves a review of certain environmental and social issues facing a company. While ISS has stated that it maintains an internal firewall between its corporate and institutional businesses, many companies believe that they need to purchase ISS' corporate consulting services in order to get a fair hearing from ISS' institutional research analysts. In addition, it appears unlikely that ISS will abandon its profitable corporate advisory business, given that it has been growing more quickly than its institutional proxy advisory business.[10]

Another conflict of interest arises when an institutional client of a proxy advisor firm is also the proponent of a specific shareholder proposal -- or instigates a "vote no" campaign against directors -- that will be subject to a voting recommendation by that same proxy firm. ISS and Glass Lewis have many clients that are public pension funds or labor union funds, which are among the most aggressive filers of shareholder proposals and organizers of "vote no" efforts. Glass Lewis is owned by the Ontario Teachers' Pension Plan Board, which manages a fund with more than $100 billion in assets. The influence of activists can be seen in the voting policies of the proxy advisors. As James K. Glassman and J.W. Verret observed in a recent academic paper on proxy advisors, both proxy firms also have shown a tendency toward ideological bias in their recommendations, especially on issues that involve labor union power, executive compensation, and the environment.[11]

Given that proxy advisors are critical intermediaries between companies and their institutional investors, the proxy firms should be required to provide full disclosure on all of these conflicts of interest so investors can adequately judge whether to follow their recommendations.

Recommended Reforms for Proxy Advisory Firms

NIRI, as part of the Shareholder Communications Coalition (which includes the Society of Corporate Secretaries and the Business Roundtable), has urged the SEC for years to take action to address the business practices of proxy advisors. In recent years, there has been a growing chorus of companies and former and current SEC officials who believe that urgent action is needed.[12] Unfortunately, the SEC has failed to act on these critical issues, but we hope that this Subcommittee concludes that these reforms should be a greater priority.

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[10] *See* MSCI Inc., Form 10-K for the Year Ended December 31, 2012, (March 1, 2013): 54, available at: https://www.sec.gov/Archives/edgar/data/1408198/000119312513087988/d448124d10k.htm#toc448124_11 (MSCI is the corporate parent of ISS).

[11] James K. Glassman and J. W. Verret, "How to Fix Our Broken Proxy Advisory System," Mercatus Research, George Mason University (April 16, 2013), available at: http://www.shareholderforum.com/e-mtg/Library/20130416_Mercatus-report.pdf

[12] Former SEC Chairman Harvey Pitt and former Commissioner Paul Atkins are among the ex-agency officials who have voiced concern over the role of proxy advisors. More recently, Commissioner Daniel M. Gallagher raised a series of thoughtful questions about proxy advisors that regulators and investors should address. *See* Commissioner Daniel M. Gallagher, "Remarks at 12th European Corporate Governance & Company Law Conference" (Dublin, Ireland, May 17, 2013), available at: http://www.sec.gov/news/speech/2013/spch051713dmg.htm

The following is a summary of our recommendations:

1. *Proxy advisory firms should be subject to more robust oversight by the SEC.* All proxy firms should be required to register as investment advisers and be subject to the regulatory framework under the Investment Advisers Act of 1940. In addition, the SEC's Division of Corporation Finance, which oversees corporate disclosures and proxy issues, should play a prominent role in providing oversight.

2. *The SEC should adopt new regulations that include minimum standards of professional and ethical conduct to be followed by the proxy advisory industry.* The goal of a uniform code of conduct -- which should address conflicts of interest, transparency of processes, and accuracy of factual information -- should be to improve the quality and reliability of the analysis and advice provided by proxy advisory firms.[13]

3. *These SEC regulations should require full disclosure of conflicts of interest.* A proxy advisory firm should publicly disclose its relationship with any client who is the proponent of a shareholder proposal or a "vote no" campaign, whenever the proxy advisory firm is issuing a recommendation to other clients in favor of the same proposal or "vote no" campaign.

4. *The SEC should address whether a proxy advisory firm should be allowed to offer consulting services to any public company for which it is providing recommendations on how investors should vote their shares.* If a proxy advisory firm is allowed to offer such consulting services, consideration should be given to ensure there is a complete separation of proxy advisory activities from all other businesses of the firm, including consulting and research services.

5. *Given the tremendous influence of proxy advisory firms, there should be greater transparency about the internal procedures, guidelines, standards, methodologies, and assumptions used in their development of voting recommendations.* This is particularly the case where the advisors apply policies without taking into account company-specific or industry-specific circumstances in making voting recommendations. This increased transparency would enable shareholders and companies to better evaluate the advice rendered by proxy advisory firms. These firms should be required to maintain a public record of all their voting recommendations. The SEC should also consider requiring the disclosure of the underlying data, information, and rationale used to generate specific voting recommendations. These disclosures could be made within a reasonable time after the recommendation has been made and still be relevant and useful to companies, investors, academics, and others who study the influence of proxy firms.

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[13] The concern over the role of proxy advisors is not limited to the United States. As noted in a recent speech by Commissioner Gallagher, the European Securities and Markets Authority has called on proxy advisors to adopt a code of conduct that addresses conflicts of interest and fosters transparency to ensure the accuracy and reliability of the advice provided to investors.

6. *Proxy advisory firms should be required to provide all public companies with draft reports in advance of distribution to their clients, to permit companies to review the factual information contained in these reports for accuracy.* Companies should be allowed a reasonable opportunity (such as 48 hours) to conduct this review and to respond to any factual errors. The SEC should consider whether to require proxy advisors to include in their reports any information they receive from a company, or, at a minimum, indicate in that report that a company disagrees with a particular factual assertion.

7. *Proxy advisory services should disclose publicly and promptly any errors made in executing or processing voting instructions on a particular proxy vote.*

MODERNIZING SHAREHOLDER COMMUNICATIONS

NIRI appreciates this Subcommittee's interest in exploring ways to modernize the current proxy system, including current disclosure practices to improve communications between public companies and their shareholders.

NIRI supports measures to improve the U.S. proxy system, the roots of which were established more than 30 years ago. NIRI believes these principles are critical to ensuring confidence in U.S. capital markets:

- An effective, accurate, and transparent proxy system that ensures equality among shareholders is a fundamental element of healthy capital markets.
- Efficient two-way corporate-investor communications are integral to such a proxy system.

These principles will also ensure that public companies are provided a more modern foundation from which to focus valuable corporate resources on growth and innovation, instead of bearing the expense of an outdated proxy system.

As referenced earlier, the SEC in 2010 issued a concept release seeking public comment on the U.S. proxy system and asking whether rule revisions should be considered to promote greater efficiency and transparency and enhance the accuracy and integrity of the shareholder vote. NIRI submitted a comment letter on this concept release, and although there have been no subsequent regulatory action to improve the proxy system, NIRI and other organizations continue to voice strong support for improved shareholder transparency and communications.[14]

To better understand these issues, it is helpful to review the aspects of our complex and outdated proxy system that prevent companies from knowing the identities of all of their shareholders.

[14] NIRI, "Comment Letter on the SEC's Concept Release on the U.S. Proxy Voting System" (Oct. 20, 2010), available at: http://www.niri.org/Main-Menu-Category/advocate/Regulatory-Positions/NIRI-Comment-Letter-re-SEC-Proxy-Concept-Release-Oct-2010.aspx.

The Growing Disconnect Between Companies and Shareholders

Over the past several decades, the percentage of public company shares held in "street name" -- which are held in the name of a broker, bank, or other financial intermediary rather than being "registered" in the name of the actual investor -- has grown dramatically from 25 percent to more than 80 percent, according to New York Stock Exchange estimates.[15] The benefit of this "street name" system is that it enables an efficient transfer of shares among owners and promotes greater liquidity in our capital markets. However, an important consequence is that it is virtually impossible for companies to know who owns their stock given this migration to shares held in street name (where the name of the investor is shielded from companies), combined with the growing use of alternative trading systems (also known as "dark pools"), and the decoupling of equity listings from their trading venues.

A company's ability to communicate also is hindered by the "Objecting Beneficial Owner" (OBO) versus "Non-Objecting Beneficial Owner" (NOBO) shareholder classifications. Street name shareholders, as part of the process of establishing their brokerage accounts, have the option of allowing their contact information to be released to the company and receiving communications directly from the company (NOBO), or remaining anonymous (OBO). While companies can purchase NOBO information, this information takes several days to compile and quickly becomes out of date as shares are traded by investors each day. Consequently, it is both costly and ineffective for companies to communicate with these NOBO investors. These communication challenges negatively impact all shareholders, particularly "retail" (or individual investor) shareholders who hold almost 40 percent of street name shares, and have been voting less on proxy matters in recent years.

As public companies' mandatory disclosures become more complex and voluminous, retail participation in the governance process may continue to decline. Current statistics indicate that only 14 percent of retail shareholder accounts vote their proxy ballots, according to Broadridge Financial Solutions. While anecdotal, there is a perception among retail shareholders with small or modest positions that their vote doesn't matter. Under the current system, a company's primary tools to encourage voter participation are general educational communications and the retention of a proxy solicitor, which is expensive and may not be effective.

Public companies' communications to shareholders are further hampered by the SEC's outdated ownership disclosure rules for institutional investors. Current SEC rules (Section 13(f)) generally require certain institutional investors to disclose share ownership positions only on a quarterly basis, with an exception made for those who petition the SEC to delay these disclosures on the basis of confidentiality. While not specifically designed to help companies identify their larger shareholders, Congress established this reporting regime in the 1970s to require certain larger investment managers to report their equity positions. The practical effect of this rule is that an investment manager may, for example, buy or sell shares on January 1 and not have to report that

[15] NYSE Euronext, "Recommendations of the Proxy Fee Advisory Committee to the New York Stock Exchange" (May 16, 2012), available at: https://usequities.nyx.com/sites/usequities.nyx.com/files/final_pfac_report.pdf

holding change until May 15, more than 19 weeks after the transaction. Many U.S. companies hold their annual meetings during this period, when shareholder communications are even more crucial. This quarterly reporting scheme was obviously established many years ago before technological advances improved the availability of information. This delayed reporting by investors further compounds the communication difficulties for public companies, given the trends toward greater shareholder anonymity (through street name registration) and the declining rates of retail voting.

Communicating with and educating shareholders is a crucial part of encouraging retail investors to vote their shares. All parties to the proxy system – public companies, exchanges, broker-dealers, regulators, and service providers – play a role in educating investors. NIRI believes that timely, unbiased education will become increasingly important as companies have to provide even more complex and voluminous disclosures to comply with the Dodd-Frank Act and new SEC rules.

Corporate Governance Trends Accelerate Need for Improvement

Recent governance trends and regulatory changes (such as those mandated by the Dodd-Frank Act) give shareholders more say over executive compensation and other corporate governance matters. This shareholder empowerment further increases the need for regulators to address current barriers to corporate-shareholder communication. Public companies must be able to accurately identify and communicate directly with shareholders to ensure they can make informed decisions in the best interest of all shareholders.

It is important to understand the potential ramifications from this increased shareholder influence. Among others, these activities include:

- *Increased shareholder activism:* Shareholder activists have more influence on corporate matters; some of these investors are encouraging proposals that advance their own self-interest, to the detriment of the interests of all shareholders.
- *Growing influence of proxy advisory services:* Institutional investors often base their voting decisions on the recommendations of proxy advisory firms. As mentioned previously, SEC officials, companies, and academics have raised concerns about the influence of these firms, the accuracy of their reports, and the potential conflicts of interest.
- *Greater annual meeting costs:* The cost of annual meetings will likely rise due to an increase in the expenses associated with preparing proxy materials, employing proxy solicitors to identify and communicate with shareholders to meet quorum requirements, and other proxy voting costs. These administrative costs will reduce the amount that companies can spend to hire new employees and grow their businesses.

As we move toward an environment of greater shareholder influence on corporate governance matters, the ability of companies to identify their investors, communicate directly with them, and encourage them to vote will remain a high priority, particularly in close vote situations or even simply to achieve quorum.

Recommended Proxy System and Shareholder Communications Reforms

The current shareholder voting and communications system is more than 30 years old, and is a product of regulatory evolution rather than a thoughtful forward thinking design. NIRI, alone and together with other groups, has called for the following regulatory reforms to the current U.S. proxy and shareholder communications system:

1. *Improve Institutional Investor Equity Position (13F) Reporting.* The ownership reporting rules under the Section 13(f) reporting scheme should be amended to improve the timeliness of 13(f) reporting from 45 days after the end of the quarter to two days after the end of the quarter. Reporting rules should be strictly enforced with meaningful penalties for non-compliance.

   As part of Dodd-Frank, Congress directed the SEC to consider rules for a similar regime for short position disclosure every 30 days, so an evaluation of the entire 13(f) disclosure process follows logically.

   NIRI joined with the NYSE and the Society of Corporate Secretaries and Governance Professionals to provide the SEC with a comprehensive slate of related reforms in a Feb. 1, 2013, letter.[16] More timely information is important because it will:

   a. Increase transparency about company ownership for the market overall.
   b. Improve the dialogue between companies and their investors.
   c. Help companies to better prepare for their annual meetings.
   d. Help address corporate governance concerns.
   e. Better correlate ownership reporting rules to other SEC-based reporting requirements.
   f. Recognize and capitalize on advances in technology that make timelier reporting possible.

2. *Enhance the U.S. Proxy System.* Despite the SEC's laudable 2010 proxy system concept release, we have seen no action on any comments. NIRI submitted a comment letter with a comprehensive list of recommendations to improve several aspects of the U.S. proxy system, including those that will benefit corporate-shareholder communications.

CONCLUSION

NIRI is pleased to provide these comments as this Subcommittee considers issues concerning proxy advisory firms and improved shareholder communications. It is critical that we have an effective proxy system that is free from conflicts of interest and that allows for timely, efficient, and accurate shareholder communications. Equally important is a proxy system that is

[16] NIRI, NYSE Euronext, and Society of Corporate Secretaries, "Petition for Rulemaking Under Section 13(f) of the Securities Exchange Act of 1934" (Feb. 1, 2013), available at: https://www.sec.gov/rules/petitions/2013/petn4-659.pdf.

transparent and accurate to ensure equality among shareholders. A modernized institutional disclosure system that allows companies to communicate effectively and efficiently with investors would increase public confidence in the integrity of the U.S. securities markets and potentially help pave the way for accelerated growth and innovation.

As noted in the House Report for the Shareholder Communications Act of 1985:

> Informed shareholders are critical to the effective functioning of U.S. companies and to the confidence in the capital market as a whole. When an investor purchases common stock in a corporation, that individual also obtains the ability to participate in making certain major decisions affecting that corporation. Fundamental to this concept is the ability of the corporation to communicate with its shareholders.

NIRI stands ready for further discussion regarding any of the suggestions or comments made in this testimony, or about the shareholder communication practices of investor relations professionals.

Statement of the U.S. Chamber of Commerce

ON: "Examining the Market Power and Impact of Proxy Advisory Firms"

TO: The House Subcommittee on Capital Markets and Government Sponsored Enterprises

BY: Harvey Pitt

DATE: June 5, 2013

The Chamber's mission is to advance human progress through an economic, political and social system based on individual freedom, incentive, initiative, opportunity and responsibility.

The U.S. Chamber of Commerce is the world's largest business federation representing the interests of more than 3 million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations. The Chamber is dedicated to promoting, protecting, and defending America's free enterprise system.

More than 96% of Chamber member companies have fewer than 100 employees, and many of the nation's largest companies are also active members. We are therefore cognizant not only of the challenges facing smaller businesses, but also those facing the business community at large.

Besides representing a cross-section of the American business community with respect to the number of employees, major classifications of American business—e.g., manufacturing, retailing, services, construction, wholesalers, and finance—are represented. The Chamber has membership in all 50 states.

The Chamber's international reach is substantial as well. We believe that global interdependence provides opportunities, not threats. In addition to the American Chambers of Commerce abroad, an increasing number of our members engage in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on issues are developed by Chamber members serving on committees, subcommittees, councils, and task forces. Nearly 1,900 businesspeople participate in this process.

Chairman Garrett, Ranking Member Maloney, and Members of the Capital Markets and Government Sponsored Enterprises Subcommittee:

Introduction

I am pleased to participate in this Subcommittee's important hearings, at your invitation, representing the U.S. Chamber of Commerce (Chamber), to discuss the extensive, but unfettered, influence over corporate governance currently being wielded by proxy advisory firms.

By way of background, I am the founder and Chief Executive Officer of the global business consulting firm, Kalorama Partners, LLC, and its affiliated law firm, Kalorama Legal Services, PLLC (collectively, Kalorama).[1] Prior to founding Kalorama, as the Subcommittee is aware, I was privileged to serve the SEC in two separate tours of duty—first as a member of the SEC's Staff, from 1968-1978, culminating with my service, from 1975-1978, as SEC General Counsel, and second, as the SEC's 26th Chairman, from 2001-2003. In the nearly twenty-five years between my two governmental tours of duty, I was a senior partner in, and co-chaired, an international corporate law firm.

In the past forty-five years, I have served, variously, as a government policy maker and private sector advisor on a full panoply of matters affecting our capital and financial markets, publicly-held corporations, capital and financial market professionals and participants, and entities interested in, or affected by, the operations of this country's capital and financial markets. In my current role as CEO of the Kalorama firms, I am principally engaged in matters affecting corporate governance, regulatory policies and compliance-related issues. My professional experiences have provided me with an understanding of the ternary relationship between proxy advisory firms, investment portfolio manager organizations, and public companies, as well as the problematic corporate governance issues created by current practices of proxy advisory firms.

Summary

The allocation of capital to and governance of, public companies are inexorably intertwined with and vital catalysts for, our economic growth. Yet, disconcertingly, over the past decade and a half—largely as the result of governmental policies and

[1] As the Committee has requested, I have attached (as Exhibit 1) a copy of my current resume, summarizing my education, experience and affiliations pertinent to the subject matter of this hearing.

administrative rulemaking—we have experienced a continuous and sizeable drop in the existing number of U.S. public companies.[2]

Effective and transparent corporate governance systems that encourage meaningful shareholder communications are key if public companies are to thrive. Informed and transparent proxy advice can provide constructive support for effective corporate governance, but only if transparency exists throughout the process, and the advice being provided is directly correlated to, and solely motivated by, investor needs. These two essential components of effective proxy advice are currently lacking, and have been for some time.

For a number of years, the Chamber has expressed its long-standing concerns with the lack of transparency and accountability in, as well as the actual and potential conflicts of interest permeating, the operation of proxy advisory firms.[3] And, the Chamber has not been alone in voicing concerns with the operations of proxy advisory firms, both in the U.S. and globally.[4] The Chamber's concerns with certain practices and attributes of the most dominant members of the proxy advisory

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[2] *See e.g.*, D. Weild, E. Kim and L. Newport (Grant Thornton), THE TROUBLE WITH SMALL TICK SIZES, p. 16 (Sept. 2012), available at http://www.gt.com/staticfiles/GTCom/Public%20companies%20and%20capital%20markets/Trouble_Small_Ticks.pdf (drop of over 43% of the number of public companies); A. Stuart, MISSING: PUBLIC COMPANIES, CFO.com (Mar. 22, 2011), http://www.cfo.com/article.cfm/14563859 (loss of 42% of public companies listed on major U.S. exchanges).

[3] *See, e.g.*, Chamber, Letter to SEC Chairman Mary Schapiro (May 30, 2012), attached as Exhibit 2 (discussing inherent conflict of Glass Lewis recommending a favorable vote on activist measures undertaken by its owner, the Ontario Teachers' Pension Plan); *see also*, Chamber, Letter re SEC Concept Release on the U.S. Proxy System, SEC File No. S7-14-10 RIN 3235-AK43, attached as Exhibit 3.

[4] *See generally* J. Glassman & J. Verret, HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM, Mercatus Center, George Mason University ("Mercatus Paper") (Apr. 16, 2013), available at http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf (highlighting significant concerns regarding the role of proxy advisory firms in the U.S. capital markets). The European Securities and Markets Authority ("ESMA") has focused substantial attention on proxy advisory firms in recent years. In March of 2012, ESMA published "Discussion Paper: An Overview of the Proxy Advisory Industry, Considerations on Possible Policy Options," available at http://www.esma.europa.eu/system/files/2012-212.pdf. More recently, on February 19, 2013, ESMA published its "Final Report on The Proxy Advisor Industry," available at http://www.esma.europa.eu/system/files/2013-84.pdf. These publications identify European regulatory concerns regarding the independence of proxy advisory firms, as well as the accuracy and reliability of the advice these firms provide, as problems that warrant the formation of an industry-wide EU Code of Conduct to identify, disclose and manage conflicts of interest and otherwise enhance transparency and integrity in the proxy advice industry. In addition, on June 21, 2012, the Canadian Securities Administrators ("CSA") voiced its concerns regarding the proxy advisory industry. *See* Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms, available at http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20120621_25-401_proxy-advisory-firms.htm, and called for discussion aimed at resolving a variety of concerns, including (1) potential conflicts of interest; (2) lack of transparency; (3) potential inaccuracies and limited opportunity for issuer engagement; (4) perceived corporate governance implications; and (5) extent of reliance by institutional investors.

industry[5] are based on core tenets—transparency, accountability, and adherence to the letter and spirit of fiduciary duties—that are critical for, but frequently absent from, the practices of the dominant companies comprising this industry.

The conflicts of interest that compromise the efforts of the dominant proxy advisory firms pose a glaring hazard to shareholders, because proxy advisory firms have exercised disproportionate influence over the proxies cast by some institutional investors on behalf of these institutions' investors, often at the same time these proxy advisory firms receive compensation from the same public companies about which they are recommending voting positions to their investment portfolio management organization clients.

Proxy advisory firms are unregulated; more significantly, they operate without any applicable standards—either externally-imposed or self-imposed—and do not formally subscribe to well-defined ethical precepts, while cavalierly rejecting private sector requests for transparency in the formulation of their proxy advice, as well as increased accountability for the recommendations they make. This lack of any operable framework for such a powerful presence on economic growth and corporate governance is unprecedented in our society.[6]

Moreover, regulatory bodies have observed the growing impact of proxy advisory firms on U.S. corporate governance, combined with the lack of any coherent articulation of standards to which these firms adhere, but have not spoken definitively—in any official pronouncement—about the need for standards to govern the activities of proxy advisory firms, the importance of assuring fidelity to fiduciary principles by these entities, or the troublesome and pervasive conflicts of interest that encumber the dominant proxy advisory firms and plague recommendations they make.[7]

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[5] Two proxy advisory firms—Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis")—together comprise about 97% of the proxy advisory business. *See* Mercatus Paper, supra n. 4, at p. 8 (noting that ISS and Glass Lewis possess, respectively, a 61 percent and 36 percent market share of the proxy advisory business). Moreover, it has been estimated that ISS and Glass Lewis effectively "control" 38% of the institutional shareholders' vote, *see* Ertimur, Yonca, Ferri, Fabrizio and Oesch, David, SHAREHOLDER VOTES AND PROXY ADVISORS: EVIDENCE FROM SAY ON PAY, 7th Annual Conference on Empirical Legal Studies Paper (Feb. 25, 2013), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019239.

[6] Indeed, even the press, which is subject to First Amendment protections against the government's abridgement of the right of free speech, has subjected itself to both industry standards and individually imposed ethical and transparency requirements. *See, e.g.,* The Society of Professional Journalists Code of Ethics, available at http://www.spj.org/ethicscode.asp (instructing journalists to "avoid conflicts of interest, real or perceived; Remain free of associations and activities that may compromise integrity or damage credibility" and to "disclose unavoidable conflicts").

[7] The Securities and Exchange Commission ("SEC")—a logical agency to provide some guidance and direction for proxy advisory firms—has noted the importance of proxy advisory firms and promised to address the issues

To address this lack of articulated core principles and best practices, in March of this year, the Chamber published its *Best Practices and Core Principles for the Development, Dispensation and Receipt of Proxy Advice* (*Chamber Principles*),[8] a project on which I was privileged to participate. At a minimum, the *Chamber Principles* provide a crucial predicate for a private sector dialogue on these issues and, more broadly, provide constructive guidance for collaborative private sector efforts to repair this broken system.

Background

As the Subcommittee is well aware, investors invest capital in public companies with the expectation they will receive a positive return on their investment and be entitled, under applicable state corporation law and fundamental corporate foundational documents—charters and by-laws—to elect directors and to approve or disapprove proposals relating to the governance of the corporations in which they have invested.[9] Day-to-day management of public companies is left—as it must be—with company management, overseen by the company's board of directors.

Individual—or so-called "retail"—shareholders have the right to vote for directors and on shareholder proposals, based on the number of shares they own, but

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surrounding their activities. *See* SEC Concept Release on the U.S. Proxy System at 105-26 (July 14, 2010), available at http://www.sec.gov/rules/concept/2010/34-62495.pdf (discussing "concerns about the role of proxy advisory firms"—specifically, "conflicts of interest" and "lack of accuracy and transparency in formulating voting recommendations"). And, it has indicated that proxy advisory firms will be part of its regulatory agenda, *see* SEC Agency Financial Report for FY 2012 at 31, available at http://www.sec.gov/about/secpar/secafr2012.pdf#2012review (noting that, "in FY 2013, the SEC will develop recommendations for an interpretive release addressing issues raised in the July, 2010 'Proxy Plumbing' concept release about proxy advisory firms"); E. Chasan, SEC PLANS NEW GUIDANCE ON PROXY ADVISERS, CFO Journal (June 7, 2012) (stating that the then-Director of SEC's Division of Corporation Finance, said that, after the 2012 proxy season, "the SEC staff will look at issuing fresh 'interpretive guidance' about the fiduciary duties investors have in assessing the information they get from proxy advisers and how those services handle conflicts of interest"), http://blogs.wsj.com/cfo/2012/06/07/sec-plans-new-guidance-on-proxy-advisers/, but has not fulfilled its stated intentions. Individual SEC members have spoken out about the lack of principled and conflict-free behavior by proxy advisory firms. *See, e.g.*, SEC Commissioner Daniel M. Gallagher, Remarks at 12th European Corporate Governance Law Conference (May 17, 2013), available at http://www.sec.gov/news/speech/2013/spch051713dmg.htm; SEC Commissioner Troy A. Paredes, Remarks at Society of Corporate Secretaries & Governance Professionals, 66th National Conference on "The Shape of Things to Come" (July 13, 2012), available at http://www.sec.gov/news/speech/2012/spch071312tap.htm#P39_14566.

[8] A copy of the *Chamber Principles* is attached as Exhibit 4.

[9] Until 2002, and the passage of the Sarbanes-Oxley Act of 2002, Pub.L. 107–204, 116 Stat. 745, the laws of a corporation's state of incorporation governed the substantive rights of shareholders, while federal law governed the disclosures required when public companies solicit shareholder votes, and the methodology by which those votes are solicited. Sarbanes-Oxley's encroachment on states' substantive provision of shareholder rights was considerably expanded by the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub.L. 111–203, H.R. 4173 ("Dodd-Frank Act"). Many corporate governance issues are presented to public company shareholders in the form of so-called shareholder proposals, and are governed by SEC Rule 14a-8(d), 17 C.F.R. §240.14a-8(d).

are not obligated to do so. For a variety of reasons, retail shareholder participation in director elections and shareholder proposals has declined markedly over the years, in some cases constituting no more than five percent of the total votes held by retail investors.[10]

In contrast, institutional investors,[11] or those who pool funds of similarly-situated individuals and invest those funds with the expectation of producing a positive return for the investors whose funds they manage, are legally obligated to vote shares under their management in director elections and with respect to shareholder proposals. Some institutional investors—SEC-registered investment advisers—are specifically required to promulgate policies describing how they will vote the shares of public companies subject to their management and, a considerable period of time after votes have been cast, must disclose how they actually voted those shares.[12]

Institutional investors and institutional portfolio managers routinely invest in the equity securities of hundreds, if not thousands, of public companies. Institutional portfolio managers owe fiduciary duties of loyalty and care to the investors whose assets they manage, with respect to all activities undertaken on behalf of their clients, including exercising proxies for the portfolio securities they manage. The requisite due diligence to fulfill the fiduciary duties associated with proxy voting—learning and understanding the issues around director elections and shareholder proposals, and determining the voting position that will best further the interests of their investors—is complex, costly, and burdensome.

Thus, investment portfolio managers that exercise delegated authority to vote proxies involving public companies held in the investment portfolios they manage, often retain proxy advisory firms to assist them in appropriately exercising their important voting responsibilities and ascertaining how best to satisfy their fiduciary obligations. Proxy advisory firms provide that assistance in various forms, including

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[10] *See, e.g.*, F. Saccone, E-PROXY REFORM, ACTIVISM, AND THE DECLINE IN RETAIL SHAREHOLDER VOTING, The Conference Board Directors Notes No. DN-021 at 4 (Dec. 26, 2010), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1731362 (quoting a 2008 speech by then-SEC Commissioner Paul Atkins that noted the number of retail accounts voting, where e-proxy was used, was 5.7%, and citing to data from 2009 and 2010 demonstrating that those retail voting accounts that received notice of a proxy vote (instead of the full proxy materials) voted between 4 and 5 % of the time.

[11] Institutional investors include insurance companies; private pension funds; corporate, state, municipal and labor union pension funds; commercial banks, educational and other endowment funds, trust funds; collective investment funds; trust funds; hedge funds, SEC-registered investment advisers, private equity funds; state-registered investment advisers; venture capital funds; and mutual funds.

[12] *See* SEC Investment Advisers Act Rule 206(4)-6, 17 C.F.R. §80b-206(4)-6.

analyzing voting issues and/or providing specific voting recommendations; these firms frequently manage all aspects of the proxy process for their investment portfolio manager clients. Specifically, proxy advisory firms may:

- Research portfolio companies, including issues of relevance to director elections and shareholder proposals;
- Provide voting recommendations; and
- Cast actual votes for their clients.

Investment portfolio managers utilize one or all of these proxy advisory services.

Proxy Advisory Firms

Two firms—ISS and Glass Lewis—dominate the proxy advisory industry. Together, they control 97% of the proxy advice market.[13] More significantly, it has recently been estimated that ISS and Glass Lewis "control" 38% of the shareholder vote.[14] This means that, an identical ISS and Glass Lewis recommendation will move 38% of the shareholder vote, absent a vocal campaign against that position. This is an obvious reflection of the fact that ISS' and Glass Lewis' institutional clients frequently follow those firms' recommendations automatically. Unfortunately, advice provided by ISS and Glass Lewis is not tailored to the interests of the shareholders of each firm's investment portfolio manager clients, nor is it formulated with any consideration of the stated policies and purposes of the portfolios housing the equity securities to which the recommendations relate.

Given the huge percentage of the vote likely controlled by ISS and Glass Lewis, the failure of an issuer to comply with those firms' preferred policies saddles issuers with a large number of negative votes *before voting has even begun.* Proxy advisors, therefore, also can affect valuations and the ultimate outcomes of contests and specific transactional matters. ***As a result, ISS and Glass Lewis have become the de facto standard setters for corporate governance policies in the U.S.***

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[13] *See* n. 5, *supra.* There are other firms, such as Egan-Jones Proxy Services Inc. ("Egan Jones"), that provide a full array of proxy advisory services, as well as companies that provide research only, such as Manifest Information Services Ltd.,, although these firms have negligible market presence.

[14] ISS reportedly influences 24.7% of the votes cast, and Glass Lewis reportedly influences 12.9% of the shareholder vote. *See* n. 5, *supra.*

A recent example of the significant power wielded by these two firms is worth highlighting for the Subcommittee. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) includes a provision requiring shareholders of public companies to be given a non-binding, advisory, vote on executive compensation, otherwise known as "Say on Pay."[15] In doing so, Congress explicitly provided that shareholders should determine whether the frequency of such "Say on Pay" votes should occur at intervals of one, two or three years.

Putting to one side whether Congress should have mandated shareholder votes on executive compensation, this Dodd Frank Act provision's structure permitted shareholders to determine the frequency of such votes best fitting each public company's needs, affording them the flexibility to match the shareholders' advisory vote with the term of the company's compensation packages, normally three years. ISS and Glass Lewis announced an ironclad recommendation that, in *all instances* the frequency of "Say on Pay" votes should be yearly. The advisory firms did this without any evidence whether a particular frequency of voting cycle would provide better shareholder return than a different cycle, or whether differences among companies might warrant a frequency cycle longer than one year.

A frequency cycle of one year means that institutional investors must re-evaluate their portfolio companies' compensation practices every year, even if particular portfolio companies fix their executives' compensation on a three-year review cycle. Apart from the utter waste and meaninglessness fostered by the iron-clad ISS/Glass Lewis position on this issue, the one year cycle they vigorously recommended, by definition, means that most, if not all, of the two firms' institutional portfolio manager clients will need to retain ISS and Glass Lewis to fulfill their obligation to vote yearly on executive compensation.

Interestingly, there was no disclosure by ISS or Glass Lewis of their conflict of interest in recommending an iron-clad one-year voting cycle on executive compensation for every single public company. This lack of disclosure could have occurred for one of two reasons—either one or both firms were totally insensitive to their conflict of interest in recommending an annual vote on this issue, or one or both were aware of the conflict but decided not to disclose it. Either way, their failure to disclose the conflict inherent in their recommendation is itself damning evidence of the need for even minimal standards to govern how proxy advisory firms render their services.

[15] Dodd-Frank Act §951 (adding new §14A(a) to the Securities Exchange Act of 1934).

Of course, by recommending a one-year frequency vote, ISS and Glass Lewis have likely procured additional advisory business yearly. Moreover, in making a one-size-fits all recommendation that a "Say on Pay" vote must be held annually for all companies, ISS and Glass Lewis thwarted the public policy determination Congress made to permit shareholders to tailor the frequency of this vote to the circumstances of each company. It is not often that any industry in our society has the ability, single-handedly, to override Congressional policy. More importantly, the ISS/Glass Lewis recommendations effectively eviscerated the ability of corporate shareholders to debate and decide the issue.

This was all done without any study or empirical evidence on how the frequency of "Say on Pay" votes affects shareholder values, either in general or vis-à-vis specific companies. In fact, a recent study by the Center for Corporate Governance at Stanford University's Graduate School of Business concluded that proxy advisory firms' preferred compensation policies actually have a *negative* effect on share value.[16] Nevertheless, because of ISS' and Glass Lewis' recommendations, Dodd-Frank Act was rewritten to provide for a universal one year "Say on Pay" votes.[17]

Despite this market dominance and influence on corporate governance policies, the proxy advisory industry has been beset by problems, enmeshed in frequent conflicts of interest and generally shown great resistance to standards that might improve their performance and avoid eventual governmental oversight.[18] The lack of transparency and accountability of proxy advisory firms is a troubling trend that undermines confidence in, and stalls progress of, strong corporate governance. The role of proxy advice has become increasingly important as the number and complexity of issues on proxy ballots has grown exponentially. And yet, proxy advisors have not taken steps to ensure their voting recommendations are developed based on clear, objective, and empirically-based corporate governance standards to help management and investors evaluate and improve corporate governance as a means of increasing shareholder value.

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[16] D. Larker, A. McCall and G. Ormazabal, THE ECONOMIC CONSEQUENCES OF PROXY ADVISOR SAY-ON-PAY VOTING POLICIES, Stanford Graduate School of Business Research Paper No. 2105 (July 5, 2012), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

[17] In theory, individual public companies could have waged campaigns against the ISS/Glass Lewis position of a universal one-year frequency cycle for Say on Pay votes, but the costs of waging such a campaign would have been prohibitive, especially given the likelihood that at least 38% of the votes were initially aligned against such a campaign. While Congress does not subject its legislative efforts to a meaningful cost-benefit analysis, this is one area where the Country could have benefitted from such an analysis.

[18] *See* ISS Response to the U.S. Chamber of Commerce's Guidelines for Proxy Advisory Firms (Mar. 21, 2013), available at http://www.issgovernance.com/press/issresponsechamberofcommerce.

While ISS and Glass Lewis purport to be striving for transparency and accountability in the corporate governance ***of others***, these firms show no inclination toward applying to themselves the same standards they recommend others follow. Transparency and accountability are missing vis-à-vis the way ISS and Glass Lewis develop voting policies and recommendations. Thus, for example, although ISS is a *de facto* governance standard setter for corporate America, akin to the accounting pronouncements of the Financial Accounting Standards Board, ISS does not follow even the more mundane and ministerial general procedures or guidelines all legitimate and non-self-anointed private sector and governmental standard setters follow when ISS changes its annual voting policies, such as a providing a public comment and notice period. Without adequate procedures, it is unclear who (and what) really drive ISS' policy updates. Additionally, ISS' almost simultaneous release of voting policies with the closure of an unnaturally short comment period call into question whether letters submitted to ISS by public stakeholders are understood, considered, or even read.

Similarly troubling, ISS may afford larger companies twenty-four hours to review and respond to company-specific recommendations, but other companies are provided absolutely no opportunity to review or respond to these company-specific recommendations whatsoever.[19] There is no basis for this discriminatory practice on ISS' part. Indeed, it could be argued that most of its clients have the capacity to ferret out information about the largest public companies by themselves, whereas very few—if any—would have the ability to find out much about smaller companies that ISS totally excludes from any participation in ISS' fact-finding and formulation of recommendations.[20]

Glass Lewis, in turn, is a "black box" that does not permit any type of input or dialogue into its fact-finding and recommendation-formulation processes. Nor does Glass Lewis conduct a general public review of its policy positions and updates.

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[19] To follow-up on an active dialogue that the Chamber had fostered with corporate secretaries and ISS to correct some of these flaws, the Chamber in 2010 wrote to ISS and the SEC with a proposal to inject transparency and accountability into this system by creating Administrative Procedure Act-like processes for voting policies and recommendations. *See* memorandum from U.S. Chamber of Commerce to ISS (August 4, 2010), available at http://www.sec.gov/comments/s7-14-10/s71410-268.pdf. This would have allowed for an open dialogue in which all stakeholders could have participated, and would have better informed ISS of circumstances material to the interests of its clients. To date ISS has not acted or commented on these recommendations.

[20] One could speculate that the reason ISS denies smaller public companies any opportunity to comment is that such smaller firms are less likely than larger companies to become ISS clients. Another speculative rationale for it approach may be that ISS does not devote adequate resources to researching smaller public companies, perhaps utilizing generic policy positions to formulate its recommendations; if that were the case, permitting comment by smaller companies might consume energies and resources ISS is unwilling to expend in formulating its positions with respect to such smaller-sized companies.

Rather, for most observers, the first glimpse of Glass Lewis' annual policy updates occurs *after* Glass Lewis' policies have already been finalized. It is of enormous concern as well that Glass Lewis does not provide public companies with the chance to review and respond to recommendations.

The stakes for many public companies are quite high—director elections, major corporate transactions and significant shareholder proposals all can have an enormous impact on the companies confronting those issues and, even more importantly, can have a profound effect on the shareholders who have invested in those companies. By refusing to provide any input whatsoever into its positions, Glass Lewis appears affirmatively to embrace the notion that it would rather base its position on factual errors than take the time to ensure that its positions are based on factually correct premises. No other industry—whether its members are government regulated or merely faithful to industry best practices—could survive such a cavalier disrespect for factual accuracy, fairness and transparency.

ISS and Glass Lewis also are subject to potential conflicts of interest that impair the reliability, fairness and accuracy of their recommendations. ISS operates a consulting division that provides advice to the same public companies about which ISS opines and influences institutional votes, including selling advice on the ways these companies can achieve better ISS corporate governance ratings. In fact, ISS' ownership of this consulting arm—accepting fees from both the institutional investors who receive their voting advice as well as from the public companies that are the subject of their voting advice—has been a focal point for criticism of the conflicts of interest inherent in this business model, including criticism from the firm's former CEO.[21]

It should also be mentioned that ISS s, when making recommendations on a shareholder proposal of competing slates of directors, do not disclose if the proponent of the proposal or slate is a client.[22]

Notably, just two weeks ago, ISS settled SEC charges that ISS' failure to establish or enforce written policies and procedures enabled an ISS employee to provide information to a proxy solicitor concerning how more than 100 of ISS' institutional shareholder advisory clients were voting their proxy ballots. Without admitting or denying the allegations, the firm agreed to pay a $300,000 fine and to

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[21] M. Murphy, "Nell Minow Says Governance Has a Long Way to Go," CFO Journal (June 26, 2012), available at http://blogs.wsj.com/cfo/2012/06/26/nell-minow-says-governance-has-a-long-ways-to-go/?mod=wsjpro_hps_cforeport.

[22] *See* Glass Lewis Conflict of Interest Statement, available at http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/.

engage an independent compliance consultant to review its supervisory and compliance policies and procedures.[23] Although virtually all business enterprises have policies regarding the handling of the type of information that the ISS employee misused, ISS' failure to adopt such procedures and policies is consistent with its long-standing opposition to developing reasonable policies and procedures regarding any aspect of its proxy advisory activities.

It is also significant that Glass Lewis is owned by an activist institutional investor—the Ontario Teachers' Pension Plan—and yet Glass Lewis takes positions on the precise issues its parent company forcefully advocates for public U.S. companies. The Chamber has written the SEC on several occasions regarding the apparent conflict of interest presented by the issuance of Glass Lewis recommendations in favor of activist measures undertaken by its owner.[24] To date, however, the SEC apparently has taken no action in response to these events, and has not provided the Chamber with a substantive response. The Chamber also wrote to the Department of Labor (DOL), asking that it also look into these matters, as the advice ERISA pension funds receive must be linked to shareholder return and free of potential conflicts of interest.[25] To date, the DOL apparently has taken no action in response to these events, and also has not provided the Chamber with a substantive response.

Concerns also have been raised that certain politically-motivated clients of both ISS and Glass Lewis disproportionately influence those firms' vote recommendations, and the policies they are based on, to advance a political agenda that is not geared towards improving shareholder return.[26] This is particularly troublesome, given the recent rise in the number of shareholder proposals related to political spending disclosures. The concern here is that certain politically-motivated shareholders may be attempting to use corporate governance processes to silence corporate speech, rather than to increase shareholder returns, and ISS and Glass Lewis may be

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[23] *In the Matter of Institutional Shareholder Services Inc.*, Inv. Advisers Act Rel. No. 3611 (May 23, 2013), available at http://www.sec.gov/litigation/admin/2013/ia-3611.pdf.

[24] *See* Letter from Tom Quaadman to SEC Chairman Mary Schapiro (May 30, 2012), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-5.30-Glass-Lewis-letter-release.pdf; Letter from Tom Quaadman to SEC Chairman Mary Schapiro (Sept. 12, 2011), available at http://www.sec.gov/comments/s7-14-10/s71410-301.pdf.

[25] *See* Letter from Tom Quaadman to Assistant Secretary of Labor Phyllis Borzi (June 25, 2012), available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-6.25-DOL-Letter-re-Glss-Lewis-Canadian-Pacific.pdf.

[26] *See* J. Glassman & J. Verret, FIXING THE BROKEN PROXY SYSTEM, Bloomberg (Apr. 23, 2013), available at http://www.bloomberg.com/news/2013-04-23/proxy-firm-debacle-can-be-reversed.html.

affirmatively embracing those efforts, rather than focusing their efforts on improving shareholder results.

Additionally, serious questions have been raised about the quality and rigor of the research undertaken by proxy advisory firms. For instance, ISS apparently employs 180 analysts to evaluate 250,000 issues, spread over thousands of companies, within a six-month period known as proxy season.[27] As noted above, "Say on Pay" votes have become an annual event for U.S. public companies, and thus an annual recommendation for proxy advisory firms. In forming its "Say on Pay" recommendations, ISS compares companies' compensation levels against groups of companies that ISS deems to be the comparable.

But, ISS does not disclose how it develops these so-called "peer groups," or the criteria on which these "peer groups" are predicated. Not surprisingly, these "peer groups" have generated heavy criticism due to the inconsistent standards utilized to form them, and the inaccurate bases on which these so-called "peer groups" are predicated.[28] This criticism is not without legitimacy, as hotels have found their ISS-selected "peers" to include automotive-parts companies and holding companies involved in numerous business segments.[29] Indeed, during the last full proxy season, ISS's poor "peer group" formulations, combined with its unwillingness to amend poorly constructed and unrepresentative "peer groups," prompted a number of companies to take the extraordinary step of filing additional proxy materials following receipt of ISS's report to educate investors on the inappropriateness of the "peer group" chosen by ISS.[30]

These issues with proxy advisory firms have set back the cause of good corporate governance and, if unaddressed, may have the potential to reverse otherwise

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[27] *Chamber Principles* at 3, available at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

[28] *See, e.g.*, P. Park, CORPORATE GOVERNANCE WATCH: COMPANIES CRITICIZE ISS OVER PEER GROUP SELECTION METHODOLOGY, Business Law Currents, Thomson Reuters Westlaw (May 17, 2013), http://currents.westlawbusiness.com/Article.aspx?id=444afa88-6898-4913-bece-8233280a2390&cid=&src=&sp=.

[29] *See* E. Chasan, WATCHDOG CHALLENGED OVER PAY BENCHMARKS, CFO Journal (May 8, 2012) available at http://blogs.wsj.com/cfo/2012/05/08/watchdog-challenged-over-pay-benchmarks/; *see also See, e.g.*, P. Park, CORPORATE GOVERNANCE WATCH: COMPANIES CRITICIZE ISS OVER PEER GROUP SELECTION METHODOLOGY, *supra* n. 29 (criticizing ISS' selection of "peer groups," such as a coal company and transportation company as peers for an oil and gas storage company); S. Quinlivan, ISS' PEER GROUPS BEGIN TO SPUR COMPLAINTS, Making Sense of Dodd-Frank, DODD-FRANK.COM (Mar. 23, 2012), available at http://dodd-frank.com/iss%E2%80%99-peer-groups-begin-to-spur-complaints/

[30] *See e.g.*, J. Barrall, PROXY SEASON 2012: THE ROLE OF SUPPLEMENTAL PROXY SOLICITATIONS, Los Angeles & San Francisco Daily Journal (June 18, 2012), available from http://www.lw.com/thoughtLeadership/proxy-season-2012-supplemental-proxy-solicitations.

positive advances in corporate governance, such as increased communications and the empowerment of directors and shareholders that have occurred over the past few decades.

Relevant Factors

Rule 206(4)-6

In 2003, while I was the Chairman of the SEC, the Commission adopted Investment Advisers Act Rule 206(4)-6, requiring registered investment portfolio management organizations to adopt and disclose policies regarding how portfolio managers would vote the securities in their various managed portfolios. The Commission specifically noted that an investment portfolio manager's fiduciary duties encompassed the voting of portfolio securities. In so doing, the SEC recognized that investment advisers, either directly or indirectly through affiliates, may have relationships with issuers that could potentially influence the decision-making of the investment adviser in exercising client proxy votes, thereby compromising the adviser's independence and violating the adviser's fiduciary duty to act in the best interests of its clients.

Notably, the SEC's only mention in its release proposing the adoption of Rule 206(4)-6 of proxy advisory firms was indirect, and was made in reference to the investment adviser policies, indicating that

> [t]he extent to which the adviser relies on the advice of third parties or delegates to committees should also ordinarily be covered by the policies.[31]

Consistent with the extremely limited attention in the Rule 206(4)-6 Proposing Release dedicated to proxy advisory firms, the Commission's release announcing the adoption of the Rule included only a single sentence referencing an investment adviser's use of a proxy advisory firm; it noted that

> [a]n adviser could demonstrate that [its] vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-

[31] Proxy Voting by Investment Advisers Proposed Rule at II.A.2. Rel. No. IA-2059; File No. S7-38-02 (Sept. 20, 2002), available at http://www.sec.gov/rules/proposed/ia-2059.htm.

> determined policy, based upon the recommendations of an independent third party.[32]

The "conflict of interest" referred to was the possible conflict between an investment adviser and a third party—to wit, the focus of Rule 206(4)-6 more generally—not to a possible conflict between the third party and the corporate issuer. Indeed, at the time, I discussed the catalyst for this rule being potential conflicts of interest that mutual fund investment advisers face in voting their shares. Specifically, I explained that,

> because the securities are held for the benefit of the investors, they deserve to know the fund's proxy voting policies and whether [those policies] were in fact followed. Many wield voting power in the face of conflicts; they may cast votes furthering their own interests rather than those for whom they vote.[33]

The Staff's "No-Action" Letters

After my tenure as Chairman ended, in 2004, the SEC Staff profoundly changed the requirements of Rule 206(4)-6 by issuing a "no-action letter" to Egan-Jones (Egan-Jones No-Action Letter) on May 27, 2004,[34] as supplemented by a subsequent "no-action letter" issued to ISS (ISS No-Action Letter) on September 15, 2004 (collectively, No-Action Letters).[35] As a practical matter, the No-Action Letters had the legal effect of permitting registered investment advisers to rely exclusively on a proxy advisory firm's ***general*** policies and procedures pertaining to conflicts of interest—as opposed to any specific conflicts a proxy advisory firm might have with respect to a particular issue or a particular company about which the proxy advisory firm might make a recommendation—to determine if the proxy advisory firm was independent and could be relied upon to cast a vote for the investment adviser, without the adviser being deemed to have violated Rule 206(4)-2 of the Investment Advisers Act or any other provision of the federal securities laws.

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[32] Proxy Voting by Investment Advisers Final Rule at II.A.2.b., 17 CFR 275, Rel. No. IA-2106, File No. S7-38-02 (Mar. 10, 2003), available at http://www.sec.gov/rules/final/ia-2106.htm.

[33] Chairman Harvey L. Pitt, SEC, "Speech by SEC Chairman: Remarks at the Commission Open Meeting," (Jan. 23, 2003), http://www.sec.gov/news/speech/spch012303hlp.htm.

[34] Egan-Jones Proxy Services, SEC No-Action Letter (May 27, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/egan052704.htm.

[35] Institutional Shareholder Services, Inc., SEC No-Action Letter (Sept. 15, 2004), *available at* http://www.sec.gov/divisions/investment/noaction/iss091504.htm.

In its Egan-Jones No-Action Letter, the SEC Staff indicated that recommendations of a third party proxy advisory firm that is independent of an investment adviser "may cleanse the vote" cast by an investment adviser of any conflict the adviser otherwise might have. In addition, the Staff announced, as a general rule that, "the mere fact that the proxy advisory firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser." The Staff noted, however, that an investment adviser "should take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances."

Soon thereafter, ISS sought clarification of the Egan-Jones No-Action Letter by asking if an investment adviser could satisfy the independence requirement of Rule 206(4)-6 if it "determines the impartiality of a proxy voting firm based on the firm's ***overall*** policies and procedures rather than on an examination of the proxy voting firm's ***specific*** relationships with individual issuers" (emphases supplied). The Commission's staff responded to ISS by providing the requested assurances that an investment adviser may, without violating Rule 206(4)-6, rely exclusively on a proxy advisory firm's general conflict policies and procedures in determining the firm's impartiality to make recommendations. Departing from the Staff's Egan-Jones letter, the SEC Staff advised ISS that "a case-by-case evaluation of a proxy voting firm's potential conflicts" is not necessary, and that an investment adviser could determine the independence of a proxy advisory firm "based on the firm's conflict procedures," without more.[36]

The No-Action Letters effectively instruct that, if investment advisers rely on recommendations of proxy advisory firms, they need not concern themselves about conflicts of interests regarding the advisory firms' specific relationships with issuers about whom the proxy advisory firms are making recommendations. While the Chamber is reviewing these issues in relation to proxy advisory firms, in other contexts the Chamber has raised concerns regarding Staff developed policies that have not been not approved by the SEC Commissioners, nor been vetted through normal Administrative Procedure Act processes, including a cost benefit analysis.

[36] The No-Action Letters are not typical SEC no-action letters, which the SEC has generally limited to informal guidance on particular circumstances and specific addressees. The SEC describes its typical no-action letter as a document "in which an authorized staff official indicates that the staff will not recommend any enforcement action to the Commission if the proposed transaction described in the incoming correspondence is consummated." SEC Rel. No. 33-6253, SEC Docket Vol. 21, No. 5 at 320-21 n.2 (Nov. 11, 1980). These letters contain no disclaimer that the Letters' contents are limited to the specific facts and circumstances presented in the requesting letters.

Chamber Principles

Given this background, and the current state of the proxy advisory industry, the Chamber believed it prudent to develop a set of core principles and best practices to serve as a basis for a dialogue among proxy advisory firms, the public companies about which they report, and investment portfolio manager organizations to which proxy advisory firms report. I was privileged to be an active participant in the development of the core principles and best practices the Chamber sought to memorialize. The ultimate goal of this effort is the development of a universally embraced private-sector system that brings transparency and accountability to the activities of proxy advisory firms, fosters strong corporate governance and ensures that benefitting public company shareholders is the paramount consideration of all operative participants in the proxy voting process.

The Chamber recognized that the best practices aspect of its efforts necessarily would require public discussion about this important component of corporate governance, and the Chamber Principles were designed to foster that public discussion and assist all participants in the proxy voting process in formulating sensible procedure to ensure that the interests of shareholders are paramount. Two proxy advisory firms exert enormous influence vis-à-vis corporate governance standards, principles, concepts, voting and have effectively become *de facto* corporate governance standard setters. The Chamber's principles are intended to focus attention on this fact and the consequences that flow from it. In addition, a critical Chamber goal is to educate the public and foster discussions regarding the current lack of standards for, and oversight of, proxy advisory firms, and the problems engendered as a result.

More regulation is not the answer. Nor is there a need for the SEC formally to "institutionalize" the Chamber Principles—the core principles already exist, as a matter of state and federal law. Rather, the Chamber believes that Congress and the SEC should encourage public companies, investors, and proxy advisory firms to engage in the necessary dialogue to create a system that will impose transparency and accountability on proxy advisory firms. This dialogue should build on other positive trends in the proxy system, including greater communication between companies and shareholders, and enhanced due diligence by asset managers in executing shareholder votes.

The Chamber has developed these best practices and core principles to improve corporate governance by ensuring that proxy advisory firms:

- Are free from conflicts of interest that could improperly influence proxy advisory firms' recommendations;
- Ensure that reports are factually correct and establish a fair and reasonable process for correcting errors;
- Produce vote recommendations and policy standards that are supported by data driven procedures and methodologies that tie recommendations to shareholder value;
- Allow for a robust dialogue between proxy advisory firms and stakeholders when developing policy standards and vote recommendations;
- Provide vote recommendations to reflect the individual condition, status and structure of each company and not employ one-size-fits all voting advice; and
- Provide for communication with public companies to prevent factual errors and better understand the facts surrounding the financial condition and governance of a company.

Conclusion

As I noted at the outset, I appreciate this opportunity to express my views on these important issues. We hope that Congress will support the Chamber's efforts to ensure transparency, accountability, and fairness in the activities of proxy advisory firms, and encourage all stakeholders to participate in this endeavor. We look forward to working with you on this important issue.

I stand ready to try to assist the Subcommittee in any way I can, and to respond to any questions the Members of the Subcommittee might have.

TOM QUAADMAN
VICE PRESIDENT

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May 30, 2012

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Schapiro:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation representing the interests of more than three million businesses of every size, sector and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy. The CCMC is highly concerned about the lack of transparency and tangible conflicts of interest in the operation of proxy advisory firms, and it has previously requested that the Securities and Exchange Commission ("SEC") exercise supervision in this area.

In this connection, the CCMC respectfully requests that the SEC closely monitor the activities of San Francisco-based proxy advisor Glass, Lewis & Co., LLC ("Glass Lewis") and its activist pension fund owner, Ontario Teachers' Pension Plan Board ("Ontario"). Earlier this month, Ontario publicly announced its opposition to the Board of Directors of NYSE-listed Canadian Pacific Railway Ltd. ("CP"), which is currently facing a proxy contest from an activist hedge fund.[1] The very next day, Glass Lewis issued its vote recommendation which, like its parent Ontario, was in opposition to the CP Board.

Both Glass Lewis and Ontario claim they make corporate governance decisions independently of one another, but the fact that the owner's interests were made known to the public just prior to publication of the subsidiary's vote recommendation demonstrates the very strong possibility that Ontario's own unique interests are being

[1] "UPDATE: Glass Lewis Supports Ackman's Canadian Pacific Board Slate" Wall Street Journal online (May 9, 2012). Available at: http://online.wsj.com/article/BT-CO-20120509-712663.html

deliberately reflected in Glass Lewis' vote recommendations, and that the mutual positions are being coordinated in some manner. The mere appearance of a tangible conflict of interest should be sufficient to justify an inquiry by the SEC.

The present situation with CP is only the most recent and perhaps most severe instance of conflicts arising with respect to Glass Lewis and the activities of its activist owner. Last September, CCMC posed a similar issue to the SEC[2], as Ontario had been publicly pressuring the McGraw-Hill Board to reorganize. In that letter, we urged the SEC to consider how the dynamic between the activist shareholder parent, and the proxy advisor that it controls, could threaten to cause serious harm to the corporate governance system, adversely impact the integrity of proxy voting systems and observance of important fiduciary duties, and hamper the long-term management of a corporation. There should be a strong regulatory interest in understanding how Glass Lewis is managing these potential conflicts, if at all, today and in the future.

The CCMC has filed several comment letters with the SEC on the Concept Release on the U.S. Proxy System (File Number S7-14-10). In these comment letters the CCMC has expressed concern regarding the unaccountability and lack of transparency in the development of voting policies and vote recommendations by proxy advisory firms. Because of the importance of advisory firms in the proxy voting system, there should be clearly defined procedures and transparency in the development of voting policies and recommendations to provide certainty in the system, while avoiding potential conflicts of interest. These procedures should be tied to actual due diligence that demonstrates consistency between voting policies and their implementation, on the one hand, and the economic interests of the actual individuals and fund participants purported to be served by the proxy advisor client. Failure of the advisory firms to avoid conflicts may harm corporate governance systems, undermine confidence in the market place, and endanger the ability of advisory firms' clients to meet their fiduciary duties as shareholders.

In commenting on the concept release the CCMC has called upon the SEC to create an oversight system to ensure the transparent development of voting policies

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[2] CCMC letter to Chairman Schapiro re: McGraw-Hill (September 12, 2011). Available at: http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/McGraw-Hill-Letter-9.12.2011.pdf

and recommendations while preventing conflicts of interests in the operation of proxy advisory firms. The CCMC continues to stand by this position and accordingly requests that the SEC to investigate the potential conflict of interest in the CP matter and closely monitor the Glass Lewis ratings, regarding the actions of its parent organization, to prevent conflicts of interest and potential degradation of corporate governance through the misuse of proxy advisory services.

We look forward to discussing this issue with you further.

Sincerely,

Tom Quaadman

CENTER FOR CAPITAL MARKETS
COMPETITIVENESS

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August 5, 2010

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Concept Release on the U.S. Proxy System
File Number S7-14-10
RIN 3235-AK43

Dear Chairman Schapiro:

The U.S. Chamber of Commerce is the world's largest business federation, representing more than three million businesses and organizations of every size, sector, and region. The Chamber created the Center for Capital Markets Competitiveness ("CMCC") to promote a modern and effective regulatory structure for capital markets to fully function in the 21st century economy. It is an important priority of the CMCC to advance an effective and transparent corporate governance structure. To achieve this objective, the CCMC has called for the elimination of regulatory dead-zones and gaps in regulatory coverage.

With the increased weight of the institutional investor vote and the heavy reliance of institutional investors on proxy advisory firms, the CCMC believes that the lack of transparency, balance, and oversight of proxy advisory firms is a troubling regulatory gap that needs to be addressed. Accordingly, the CCMC believes that the U.S. Securities and Exchange Commission ("SEC") should put in place appropriate supervision to ensure the transparent development of voting policies and issuance of recommendations to prevent disruptions and lack of confidence in the systems governing the election of directors and consideration of shareholder proposals. A failure to address this lack of supervision over proxy advisory firms may lead to the undermining of the corporate elections and annual shareholder meetings leading to adverse consequences upon investors.

Our concerns are listed in more specificity below.

Background

Because institutional investors own a majority of shares in the United States and have a fiduciary duty to vote them, the institutional investor vote has a significant impact on the outcome of corporate elections. In addition, retail investors do not have a similar legal obligation to vote their shares.[1] Because of the number of companies they are invested in, institutional investors will often delegate a proxy advisory firm to develop voting recommendations to fulfill their fiduciary duty to vote. Even before the SEC scaled back broker discretionary voting, studies suggested that proxy advisory firms' recommendations may sway up to 20% of the shareholder vote.[2] Recommendations of proxy advisory firms are potentially more influential following the SEC's action on broker discretionary voting.

Simply put, in the scope of director elections and consideration of shareholder proposals, proxy advisory firms are a highly influential group that has no regulatory oversight. Indeed recent actions by the SEC and Congress will only increase this influence. Absent reforms to the manner in which proxy advisors set and implement voting policies, such increased influence itself is prone to be out of alignment with the very interests it purports to further. Accordingly, the CCMC believes that it is necessary and appropriate for the SEC to require that proxy advisors adopt and follow operating procedures to provide assurance that the end product is derived from appropriate diligence and objectivity. This will require the development and enforcement of transparency and disclosure to create clearly identifiable rules of the road.

The CCMC believes that proxy advisors may fail to reliably represent the investors they purport to serve for the following reasons:

- ***Structural:*** Final voting recommendations and voting policies appear to be determined at the sole discretion of proxy advisors firm employees with no set guidelines or parameters. This creates a decision and policy development process that is arbitrary and capricious, potentially harmful to all investors.

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[1] The Chamber does have serious concerns regarding retail shareholder participation and will file a separate comment letter with the SEC on proposals to increase retail shareholder participation.

[2] *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, Jennifer E. Bethel and Stuart Gillan (2002)

This creates opportunities for the vote to become skewed, biased, or misdirected.

- ***Economic:*** Proxy advisors have an economic incentive to standardize and commoditize proxy voting, as a higher quality process that focuses on a vote-by-vote and company-by-company basis demands greater corporate resources. As we all know, the "devil is in the details," and the risk here is that recommendations are made in a vacuum without diligent consideration of the actual facts and context. In addition, no two companies are exactly alike and accordingly they should not be run in the same way. Unfortunately, economic incentives drive one-size-fits all policy which will not produce better informed investors or managed companies.

- ***Vocal Minority:*** Because of a lack of accountability and transparency, it appears a small vocal group of activists are able to influence the development of voting policies and recommendations of proxy advisory firms. This leads to skewed voting patterns and results. By creating transparent procedures, a more balanced system can be implemented that is more reflective of all investor interests.

- ***Outdated Approach:*** The basic model for providing proxy advice was developed decades ago and has not kept pace with the changing times. Too often, the policy pronouncements fail to be backed up by extensive analysis or how one policy inter-relates with another. The cookie-cutter approach fails to take into account differences on a company-by-company basis. The CCMC believes that the approach should be turned around: The primary focus should be on the company and its industry, and the advisor's "policies" or other such prescriptions should serve as analytical tools rather than ends unto themselves.

The CCMC proposes that the SEC consider new rules that would directly govern proxy advisors and would have a simple focus: Ensuring that proxy advisors do what they say they are in business to do. Transparency and disclosed operational standards would provide regulators and the public on-going confidence that a proxy advisor actually provides the best possible voting recommendations to its clients. It may be too much to ask that proxy advisors analyze companies in the same holistic, case-by-case manner -- and with the same attention to detail -- as a financial analyst. However, we do believe that the SEC could take simple steps to ensure that proxy advisors have procedures in place that are at the very least reasonably designed to result in quality voting recommendations. Such rules would focus each on the

process for determining voting policies and on the manner in which those policies are implemented.

First, the SEC's rules should require proxy advisors establish and disclose written standards for making recommendations, including policies that are based on statistical and other evidence that is available -- or that may reasonably be deduced. The proxy advisor should be required not only to solicit input from all stakeholders, but also to give that input due and balanced consideration in a transparent manner. The implementation of these procedures, including related internal deliberations, should be transparent so that the public can assess their effectiveness and objectivity, and offer appropriate and timely input.

Second, the SEC's rules should require that a proxy advisor has a process in place that demonstrates due care towards formulating accurate voting recommendations when applied in the unique context of each individual company. It could be similar to the government's use of the Administrative Procedure Act. As with the recommendation standards, this implementation process should be transparent. It should be apparent to the market, including the advisor's own clients, when a recommendation proves correct, and when it proves incorrect. Indeed, one consequence of such transparency might be to encourage proxy advisors to compete with each other based on the *quality* of their voting recommendations.

We are not asking that the SEC prescribe the procedures adopted and disclosed by any given proxy advisor, and indeed we believe that each advisor should remain free to devise its own approach, to experiment with new technologies and concepts. However, those procedures should be transparent and readily understood to give all participants clear rules of the road and create a degree of certainty in the process. Rather, we are asking that the SEC focus on the final product, and require that each proxy advisor does what it is in business to do – help its clients carry out their fiduciary duties when it comes to proxy voting. This approach is analogous to the procedure that the SEC has taken with credit rating agencies, by adopting rules designed to address concerns about the integrity and transparency of credit rating procedures and methodologies.

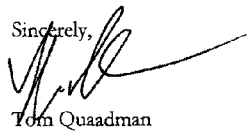
There is ample basis for such regulation inasmuch as many proxy advisor activities amount to "solicitations" and as such dependent upon corresponding exemptions from the SEC. For example, Rule 14a-2(b) (3) could be revised to further condition the availability of the exemption provided by that rule. As the courts and the SEC have made clear, fiduciary duty includes not only a duty to disclose or

manage conflicts of interest, but also a duty to ensure that votes are cast with due care.[3]

Accordingly, the CCMC respectfully requests that the SEC review the practices of proxy advisory firms and take the steps necessary, as outlined above, so they are held to standards of accountability and transparency that will make sure appropriate levels of oversight to insure investors are not improperly influenced or outcomes skewed.

The CCMC will provide more detailed comments on the proxy plumbing release, but because of the increasingly influential role that proxy advisory firm's play in the governance of companies in the U.S., we believe that the issues regarding them should be addressed quickly and on a faster track than other issues contained in the concept release. We stand ready to work with the SEC in this endeavor and look forward to any efforts to insure transparency, accountability, and fairness in proxy advisory firms' role in corporate elections and consideration of shareholder proposals.

Sincerely,



Tom Quaadman

CC: The Honorable Kathleen L. Casey, Commissioner, U.S. Securities and Exchange Commission
The Honorable Elisse B. Walter, Commissioner, U.S. Securities and Exchange Commission
The Honorable Luis A. Aguilar, Commissioner, U.S. Securities and Exchange Commission
The Honorable Troy A. Paredes, Commissioner, U.S. Securities and Exchange Commission

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[3] See, e.g., ***Final Rule: Proxy Voting by Investment Advisors***, Investment Advisors Act Release No. 2106 (Jan 31, 2003) at 2 and note 2; ***SEC v. Capital Gains Research Bureau, Inc.***, 375 U.S. 180, 194 (1963) (Interpreting Section 206 of the Advisors Act).

Best Practices and Core Principles for the Development, Dispensation, and Receipt of

PROXY ADVICE

March 2013

Center for Capital Markets Competitiveness

The U.S. Chamber's Center for Capital Markets Competitiveness has long advocated policies that promote effective shareholder participation in the corporate governance process. Strong corporate governance is a critical cornerstone for the healthy long-term performance of public companies and their positive promotion of long-term shareholder value.

Proxy advisory firms, public companies, and investment portfolio manager organizations each play an important role in ensuring that corporate governance furthers the interests of shareholders through a process that relies heavily on fair shareholder communications and informed participation.

Over the past decade, important positive strides have been made to improve corporate governance, transparency, and accountability. Sarbanes-Oxley helped foster more active and independent public company boards; there has been a welcome and necessary increase in communications among boards, management, and investors; and asset managers have increasingly established programs to enhance their due diligence in executing shareholder votes, including robust internal capabilities focused on proxy voting as well as the use of proxy advisory firms' recommendations as one of a number of data points to inform their independent proxy voting decisions.

Proxy advisory firms, public companies, and investment portfolio manager organizations each play an important role in ensuring that corporate governance furthers the interests of shareholders

However, there have also been some negative trends. In particular, annual proxy solicitations increasingly have become a referendum on a growing and sometimes conflicting array of issues. As the range of issues proposed in the name of corporate governance has grown, the need for clear, objective, and empirically based corporate governance standards has also grown to help management and investors evaluate and improve corporate governance as a means of increasing shareholder value.

Proxy advisory firms play a growing role in this process. They are called upon to evaluate every issue for which corporate proxies are solicited and, in doing so, have become *de facto* corporate governance standard setters for public companies. And yet, as the involvement of proxy advisory firms in corporate governance-related shareholder voting issues has increased, their transparency in developing and recommending voting policies has not.

Proxy Advisors are called upon to evaluate every issue for which corporate proxies are solicited and, in doing so, have become de facto corporate governance standard setters for public companies.

Best Practices and Core Principles for the Development, Dispensation, and Receipt of

PROXY ADVICE

Two firms, Institutional Shareholder Services Inc. ("ISS") and Glass Lewis & Co., LLC ("Glass Lewis"), constitute 97% of the proxy advisory industry, and one of them employs a total of 180 analysts to evaluate 250,000 issues, spread over thousands of public companies, within a short six-month period. Because of conflicts of interest (such as ISS offering consulting services to the same companies about which it renders proxy voting advice, or Glass Lewis's ownership by activist investors with defined agendas), one-size-fits-all voting advice, industry concentration, and policymaking conducted largely outside the public eye, proxy advisory firms' influence in corporate governance parallels (and pragmatically may exceed) that of formal standard setters, such as government regulators, but without the corresponding benefit of strong transparency and accountability.

We have set forth core principles and a series of specific improvements to serve as a basis for proxy advisory firms, public companies, and investment portfolio manager organizations to engage in a dialogue to create a system that brings transparency and accountability to proxy advisory firms and fosters strong corporate governance.

This has caused obstacles to good corporate governance that, if unaddressed, may reverse the positive advances in corporate governance of the past 20 years.

In order to advance this collaboration constructively, we have set forth core principles and a series of specific improvements to serve as a basis for proxy advisory firms, public companies, and investment portfolio manager organizations to engage in a dialogue to create a system that brings transparency and accountability to proxy advisory firms and fosters strong corporate governance.

Best Practices and Core Principles for Proxy Advisory Firms and Their Affiliates

Proxy advisory firms and their affiliates ("PA Firms") should provide clients with proxy voting advice that furthers the interests and objectives of their clients. To do so, PA Firms must disclose their research methodologies and conflicts of interest, and must regularly review and update their policies (based on their actual experience) to ensure that their recommendations advance shareholder value. To that end, best practices and core principles include:

Potential Conflicts of Interest

- A PA Firm's acceptance and fulfillment of client retainers certifies that the PA Firm—

  a. Has the experience, competence, and resources to provide its services with appropriate diligence;

  b. Has carefully researched and taken into account all relevant aspects of a particular issue on which it is providing advice, including information, data, and views inconsistent with its ultimate recommendation;

  c. Even after rendering initial advice, will provide clients with any information that the PA Firm receives from those companies about which the PA Firm has rendered advice; and

  d. Is fully independent and conflict-free with respect to the client and each vote involved in each assignment.

- A PA Firm should develop and disclose an appropriate methodology to ensure that it devotes appropriate resources to each assignment.

- A PA Firm should develop and disclose appropriate procedures regarding potential conflicts that may affect its recommendations; these procedures should include, among other things:

  a. Describing its current and recent interactions with its advisory clients (and affiliates);

  b. Describing its recent interactions with anyone having a material interest (positive or negative) in the subject of the advice;

c. Identifying all its recent interactions with anyone relating to the subjects of its proxy advisory services;

d. Disclosing if the proponent of any shareholder proposal on which it will provide advice is a client, or has any other relationship with the PA Firm providing benefits to the proponent;

e. Understanding, and determining whether it can facilitate, the objectives of its advisory clients;

f. Providing full disclosure to prospective clients of all potential conflicts and interrelationships, without requiring any action or analysis by its prospective clients; and

g. Affirmatively representing to prospective or existing clients, in connection with each project, the nature of any conflict that could affect its ability to render fair and impartial advice.

Advice

- A PA Firm's acceptance of an assignment certifies, among other things, that the PA Firm's advice—

  a. Relates to a subject on which the PA Firm is (or will be) competent to opine;

  b. Reflects (and sets forth) advice that carefully considered significant alternative and countervailing arguments; and

  c. Discloses the extent to which the same advice on the same subject has been (or will be) rendered to other clients, and the reasons why this advice is consistent with differing or multiple client interests and objectives.

- A PA Firm should have policies and procedures in place to ensure that the advice it provides is consistent with and in furtherance of its clients' interests and objectives.

- When communicating their recommendations to investment portfolio manager organizations ("IPMOs"), PA Firms should affirmatively advise that the recommendations

(and their underlying research) are intended solely as guidance to assist IPMs in exercising their own judgment on each significant voting issue, and that the ultimate voting decision cannot be delegated to or exercised by the PA Firm.

- PA Firms should provide IPMOs with a thorough understanding of the PA Firm's collection and use of data, as well as the methodologies that the PA Firm employs in developing advisory research.

- PA Firms should obtain from each IPMO, with respect to each engagement, a full and fair understanding of the investors' interests in managed funds.

- PA Firms should provide IPMOs with robust substantive research on relevant issues, as well as the advantages and disadvantages of any voting advice.

- In rendering advice to IPMOs, PA Firms should state in writing:

  a. The percentage of the community of funds similarly situated to those that the IPMO-client manages that received (or will receive) the same advice rendered to the IPMO-client;

  b. A reasonable time after voting ends, the percentage of similarly situated funds that received the same advice from the PA Firm and that the PA Firm reasonably believes have implemented the same advice; and

  c. The way in which the PA Firm determined that its advice furthers the interests and objectives of its clients.

<u>Research</u>

- PA Firms should adopt and disclose clear policies and procedures to ensure the accuracy of data contained in their reports and on which their recommendations are based.

- PA Firms should adopt policies and procedures to govern their communications and dealings with public companies ("PCs") and other interested persons and entities on a timely basis.

- PA Firms should provide PCs with drafts of proposed research reports relating to those PCs about which the PA Firms' research reports relate, sufficiently in advance of finalizing those reports, to enable the subject PCs to identify any factual inaccuracies or other concerns. PCs should be afforded a reasonable opportunity to seek advice about the draft research reports from external advisors, subject to appropriate confidentiality restrictions.

- PA Firms should explain their methodologies to clients in sufficient written detail.

- PA Firms should, consistent with protecting their proprietary data, provide interested persons—including PCs, IPMOs, investors, regulators, and the public—with analytical methodologies and modeling utilized in their research.

- PA Firms should review the effects of their recommendations six months, or as practicable, after relevant proxy votes, and publish those results (with other necessary data) to permit interested persons to assess the accuracy, validity, and appropriateness of the PA Firm's recommendations. Reports of these reviews should be published biannually, distinguishing between results for proposals and contests. These reviews should permit regularly revisiting and, if appropriate, modifying, proxy voting policies to ensure that they have a positive—or at a minimum no negative—effect on shareholder value.

Best Practices and Core Principles for Public Companies

PCs should engage in a dialogue with shareholders to understand their interests. As part of their broader shareholder communications strategy, PCs should endeavor to communicate with proxy advisory firms on corporate governance matters so that shareholders may evaluate what is at stake for them with respect to any matter presented for shareholder approval. With the passage of Sarbanes-Oxley and various corporate initiatives, shareholder communications, board independence, and accountability have increased. To ensure the continuation of these positive trends, the following best practices and core principles should be followed:

General

PCs typically interact with PA Firms in one of two ways:

a. PCs hold shareholder votes on a variety of matters, and encounter PA Firms when PCs solicit proxies ("Proxy Engagement"); and/or

b. PCs occasionally purchase services from PA Firms relating to corporate governance issues ("Purchasing Services"). PC Boards must discharge their fiduciary duties when interacting with PA Firms in Proxy Engagement or Purchasing Services, and must act in their shareholders' best interests.

PC Interactions with PA Firms

- Before Purchasing Services from or undertaking Proxy Engagement with a PA Firm, PCs should undertake to adequately understand, among other things:

  a. Any prevailing PA Firm and PC institutional shareholder assessments of the PC's corporate governance;

  b. General knowledge of their shareholder base and the relative likelihood that the company's shareholders would be influenced by PA Firms (or particular PA Firms) in making those voting decisions;

c. Methodologies that the PA Firm employs with respect to the types of matters on which the PC's shareholders will vote or with respect to which the PC intends to obtain a PA Firm's advice; and

d. Conflict-avoidance policies and procedures utilized by the PA Firm, especially with respect to matters of the type for which the PA Firm's services will be sought.

PC Engagement with PA Firms

- PCs should determine if the decision-making process to engage a PA Firm is a matter of routine business, or if it may be necessary to involve independent board members in decisions on whether to engage a PA Firm on specific proxy issues.

- As part of their proxy disclosure obligations, and to avoid confusion or misperceptions on the part of PA Firms, PCs should make meaningful disclosure to their shareholders of the underlying reasons for any proposal, election contest, or transaction for which shareholder votes will be sought.

- PCs should ensure timely public disclosure of all significant information that the PC intends to provide, or has provided, to any PA Firm.

- Before engaging in discussions with PA Firms about matters to be submitted to a shareholder vote, PCs should, among other things:

  a. Identify the main issues that PA Firms likely will focus upon in the next annual proxy solicitation period;

  b. Research various positions favoring or opposing the issues identified; and

  c. Develop an effective rationale for the PC's position on those issues.

- PCs should attempt to have appropriate personnel review and analyze the market's reaction to specific PA Firm recommendations and, if relevant, consider sharing that analysis with the investing public.

- PCs should publicly disclose changes they make to existing governance policies and practices as a result of their interactions with PA Firms.

PC Interactions with PA Firms as Service Providers

- In deciding whether to purchase a PA Firm's services vis-à-vis governance matters, PCs should ascertain and evaluate whether the PA Firm—

  a. Would also provide advice and recommendations to IPMOs on voting their holdings of the PC's shares;

  b. Discloses to IPMOs (in advance of or concurrently with distributing its voting recommendations) whether the PA Firm has an existing relationship with PCs about which the PA Firm renders advice;

  c. Will allow the PC to review draft recommendations that the PA Firm may be planning to make regarding voting issues, to enable the PC to correct factual errors or address misperceptions; and

  d. Renders advice tailored to the specific circumstances affecting the PC.

Best Practices and Core Principles for Investment Portfolio Manager Organizations

There is a broad variety of IPMOs—that is, persons or entities exercising or influencing investment and proxy voting decisions on behalf of, among others: individual investors; hedge funds; mutual funds; corporate, state, municipal, and labor union pension funds; endowment funds; trust funds; bank collective investment funds; investment banking firms; venture capital funds; insurance companies; and commercial banks. Because IPMOs manage or influence the disposition of the assets of others, they are obligated to ensure that their proxy voting decisions reflect their independent judgment, and are intended to further the best interests of their shareholders, investors, and clients.

Recently, some IPMOs have utilized PA Firms as one of several sources in formulating independent voting decisions on highly significant issues, consistent with the interests and objectives of their shareholders, investors, and clients. This positive trend, in conjunction with the increased dialogue between public companies and shareholders, has improved the proxy voting process. Where IPMOs are already structured to facilitate the exercise of their independent judgment, the best practices discussed below are merely suggestions of alternative ways operative core principles might be achieved. Where IPMOs are not already structured in a manner that ensures their exercise of independent judgment in satisfying proxy voting responsibilities, the following best practices and core principles are intended to guide IPMOs' receipt of necessary data from PA Firms.

General

- IPMOs must exercise independent judgment when developing and executing voting guidelines and standards with respect to highly significant and nonroutine proxy-related matters on which they receive a PA Firm's recommendations.

- IPMOs' responsibilities extend beyond the investment decisions they make, to all facets of their efforts on behalf of their shareholders, investors, and clients, including the exercise of voting power in connection with portfolio assets.

- While IPMOs can use outside experts to assist them with their responsibilities, the ultimate responsibility to act in the best interests of their shareholders, investors, and clients always remains with the IPMO.

Selection and Use of PA Firms

- IPMOs should identify the criteria they will employ, and the practices they will follow, in retaining or continuing to retain a PA Firm.

- The policies and practices pursuant to which IPMOs select PA Firms should be developed or approved by an independent authority within (or affiliated with) the IPMO. Periodically thereafter, the same independent authority should review the manner in which the IPMO's policies and procedures are implemented, to provide reasonable assurances that the selection of a PA Firm is consistent with the best interests of the IPMO's shareholders, investors, and clients.

- While many items presented for a shareholder vote are uncontested or uncontroversial, some items are contested, by their nature lend themselves to strong differing views, or can have a significant impact on shareholders. For items in the latter categories the IPMO should consider the following criteria, among others, when retaining or continuing to retain a PA Firm:

  a. Whether the PA Firm maintains transparent policies and procedures to allow an IPMO to make a reasonable determination that advice received is consistent with, and furthers, the interests and objectives of their shareholders, investors, and clients;

  b. Whether the PA Firm has adequate experience to render the type of advice for which it is being retained;

  c. Whether the PA Firm discloses actual or potential conflicts of interest related to the rendering of advice or recommendations such that the IPMO would be aware of their existence, and whether utilizing the PA Firm's advice presents actual or potential conflicts of interest within the IPMO;

  d. Whether the PA Firm has carefully considered and communicated to the IPMO significant and countervailing viewpoints known by the PA Firm;

  e. Whether the PA Firm discloses the extent—if any—to which the same advice on the same subject has been rendered to its other clients, as well as the reasons that this advice is nonetheless consistent with, and furthers, the best interests of the IPMO's clients;

f. Whether the PA Firm provides reports on internal controls to give IPMOs reasonable assurance of the accuracy of the data in their reports and recommendations;

g. Whether the PA Firm provides an adequate explanation of, and the data underlying, its methodologies and modeling; and

h. Whether utilizing the PA Firm's advice presents actual or potential conflicts of interest.

- Before selecting a PA Firm, or continuing to use a PA Firm, the IPMO should be satisfied that it understands the PA Firm's methodologies, and that both these methodologies, as well as the PA Firm's recommendations, further the interests and objectives of the IPMO's shareholders, investors, and clients.

- IPMOs should vest ultimate decision-making authority on whether and how to exercise proxy-related decisions solely in a person (or persons) possessing the ultimate authority to exercise judgment on how to vote the IPMO's shares. This does not preclude IPMOs from delegating vote execution or clerical tasks to one or more third parties (which may include a PA Firm).

- IPMOs should regularly assess and be comfortable with the performance and reliability of any PA Firm.

- In rare circumstances that IPMOs may confront potential conflicts that can affect a particular vote, those issues maybe best resolved by applying solutions appropriate to each IPMO and not standardized guidance.

Written Testimony of

Darla C. Stuckey

SVP, Policy & Advocacy

Society of Corporate Secretaries and Governance Professionals

June 5, 2013

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

"Examining the Market Power and Impact of Proxy Advisory Firms"

Introduction

My name is Darla C. Stuckey and I am Senior Vice President, Policy & Advocacy, of the Society of Corporate Secretaries and Governance Professionals (the "Society"). The Society is a professional association, founded in 1946, with over 3,000 members who serve more than 1,500 public, private and non-profit organizations. Our members seek to develop corporate governance policies and practices that support our boards to foster the interests of long term stockholders. Our members generally are responsible for their companies' compliance with the securities laws and regulations, corporate law, and stock exchange listing requirements. More than half of our members are from small and mid-cap companies.

Background

The Subcommittee has asked for our testimony on the services provided by proxy advisory firms to shareholders and issuers to determine whether these entities are providing unbiased opinions and if conflicts of interest exist. The Subcommittee has also asked for our views on the market power of proxy advisory firms, and their ability to promote agendas supported by narrow or single-issue shareholders.

Beginning in the 1980s, regulators have pushed institutions to use their voting power, with limited regard for costs of voting from an informed fiduciary standpoint. Major regulatory landmarks in this regulatory push include a Department of Labor (DOL) letter (the "Avon Letter") in 1988, and 2003 SEC rules to require that every mutual fund and its investment adviser disclose "the policies and procedures that [they use] to determine how to vote proxies". The purpose of the SEC rules was to "encourage funds to vote their proxies in the best interests of shareholders" and to avoid conflicts of interest between those shareholders and the fund's "investment adviser, principal underwriter, or certain of their affiliates."

> Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on . . . "one-size-fits-all" policies. . . . Instead of eliminating conflicts of interest, the rule simply shifted their source. Instead of encouraging funds to assume more responsibility for their proxy votes, the rule pushes them to assume less. Instead of providing informed, sensitive voting on proxies, the incentive has been to outsource decision making to two small organizations that most investors have never heard of. These two firms have emerged as the most powerful force in corporate governance in America today, shaping the way that mutual funds and other institutions cast votes on proxy questions posed by about 5,000 US public companies.[1]

[1] James K. Glassman and J. W. Verret, *How To Fix Our Broken Proxy Advisory System*, George Mason University, 2013 at page 6.

I. A SIGNIFICANT PERCENTAGE OF INVESTORS ARE INDIFFERENT TO VOTING AND THUS OUTSOURCE THEIR VOTE

Shareholdings in public companies are increasingly held by individuals through mutual funds and other intermediaries who have the right, and obligation, to vote the shares held. For this reason there is an increasing lack of connection between beneficial ownership and voting decisions. "Institutional investors vot[e] . . . portfolio company shares [by] delegate[ing] all but the most obvious economically related voting decisions to either an internal or external corporate governance team that is largely, or all too often totally, separate from the investment policy decision making team— in effect, a parallel universe of voting decision makers."[2] "Over the past decade, the SEC and Congress have increased regulation focused on institutional investors voting. An explicit assumption in this regulation was that institutional investors would conduct the research necessary to vote in a manner that would maximize value for all firm shareholders. Unfortunately institutional investors face a classic free rider problem in conducting this research and may not have economic incentives to make such an investment."[3]

Reading and analyzing proxy statements is time consuming, requiring many hours of effort and analysis. A portfolio manager or his or her in-house governance analysts would need to expend significant resources to review individually the proxy materials of each company his or her fund owns. There are few investment managers who will allocate capital to voting decisions that they believe will not generate any return on investment. In short, proxy voting, other than in a contested election or similar "bet the farm" type scenario, is simply not worth the cost. A recent study titled *Outsourcing Shareholder Voting to Proxy Advisory Firms,* David F. Larcker and Allan L. McCall, Graduate School of Business, Stanford University, and Gaizka Ormazabal, IESE Business School, University of Navarra (Draft May 10, 2013), makes this point:

> The important public policy issue in this setting is whether the payments made by institutional investors are sufficient for the proxy advisory firms to engage in costly research to develop "correct" governance recommendations from the perspective of firm shareholders. If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms.[4]

Added to this is the collective action problem inherent in the current structure of the proxy voting system. Generally, institutional investors have little incentive to give sufficient

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[2] Latham & Watkins, *Future of Institutional Share Voting Revisited: A Fourth Paradigm*, September 2011. See also, Nathan, Charles M. and Mehta, Parul, *The Parallel Universes of Institutional Investing and Institutional Voting*, April 2, 2013

[3] Larcker, David F., McCall, Allan L. and Ormazabal, Gaizka, *Outsourcing Shareholder Voting to Proxy Advisory Firms*, May 10, 2013at 43.

[4] Larcker, McCall and Ormazabal at 3.

time and resources to intelligent voting, since the investor knows that with a small ownership interest in the company, the fund's vote will have limited direct impact at a company. (A fund investor that holds 1% of the vote seldom will change the outcome of a vote; those owning less of a company's shares have even smaller direct impact.) This dynamic creates downward pressure on the quality and thoroughness of analysis related to proxy votes, particularly those that have in the past been regarded as "routine" (e.g., election of directors in non-contested situations). As proxy voting in non-contested meetings has become more important, particularly with the advent of say-on-pay, this disconnect can result in damage to the long-term interests of the company.

Thus, outsourcing these reviews to proxy advisory firms is pragmatic and rational for institutional investors, many of which say they cannot analyze the hundreds of proxy statements for their portfolio companies, particularly given the ever-increasing length and complexity of such materials.[5] Some investment managers openly tell issuers that they follow proxy advisory firm recommendations without questioning them, and without shame or embarrassment. As one Society member notes: "Many hedge funds that are in our top 25 shareholders by holdings refuse to engage with us when we call because they say that they follow ISS recommendations." And, another Society member stated that "many mutual funds buy research from proxy advisory firms; certain firms are required to justify any vote that is NOT in accordance with the proxy advisory firm' recommendations". Investment firms openly use proxy advisory firm reports as substitutes for the actual proxy statements (think Cliff's Notes). Proxy statements are subject to '34 Act and 10b5-1 liability. Proxy advisory firm reports are not, yet they are being relied upon just as heavily, if not more so, by investors to make voting/investment decisions. Furthermore, many investment managers do not even read the proxy advisory firm reports; in fact there is a "recommendation only" service from one provider that investors can purchase at a lower price that will nevertheless satisfy their compliance obligation.[6]

Outside of a proxy fight context, proxy advisory firms tend to implement mechanical policies, including check-the-box approaches that clients can tweak in "custom policies" that still are severely constrained analytically. The proxy advisory firms have an interest in perpetuating the view that such check-the-box approach to proxy voting—a demand they can fill at low cost—is adequate. We believe simple-minded voting algorithms may be an appropriate way to approach certain issues. But this method does not work well in what have become the dominant and most consequential proxy voting decisions in routine elections in the wake of various reforms enhancing shareholder power – election of directors, and executive compensation (through the advisory vote on pay).

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[5] The Society understands that some of the very largest investment managers develop their own voting guidelines and use proxy firms to "supplement" their own evaluation of agenda items. This fact notwithstanding, the influence of the proxy advisory firms is substantial.

[6] See Larcker, McCall and Ormazabal at 3.

II. PROXY ADVISORY FIRMS ARE NOT REGULATED AND HAVE NO OVERSIGHT ACCOUNTABILITY FOR THEIR RECOMMENDATIONS

As noted by the Commission in its concept release, proxy advisory firms are one of the few participants in the proxy voting process that are not generally required to be registered or regulated by the SEC. There is no accountability by proxy advisory firms even though, given the current structure of the proxy system, they control anywhere from 20-40% of the vote collectively on so-called "routine" matters at widely held companies.[7] When proxy advisory firm recommendations come out, large blocks of votes are cast almost immediately in automated voting decisions. These ripple out both from clients that follow the main policy of each advisory firm, and those that have so-called "custom policies" that are tweaked based on simplistic mechanical inputs. Proxy advisory firms are not beneficial owners of any company's shares.

Thus, the two largest proxy advisory firms each effectively control a portion of the vote that is much larger than the Schedule 13D threshold (5%), and even larger than the 10% affiliate status threshold, yet they are not subjected to any kind regulatory regime. Proxy advisory firms may produce reports with material misstatements and omissions without any legal consequences for the proxy advisory firm. One of the two dominant advisory firms, ISS, has registered as investment advisors, but no other firm has. Proxy advisory firm recommendations are tantamount to soliciting material in that they tell investors how to vote, but they are selectively disclosed only to paying customers and only sometimes to issuers.[8]

Proxy advisory firms voting policies are also unregulated. There is no regulatory regime that governs the manner in which these firms develop their policies or form the recommendations they make. The policy development process at proxy advisory firms is not sufficiently transparent.[9] It is not clear who actually participates in the process of policy development. Although ISS provides companies with an opportunity to weigh in on their policy survey, the questions often are skewed,[10] which create biased policies that seem to reflect

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[7] We believe there is a trend towards greater voting independence of large mutual fund complexes, but a large number of smaller investment managers (and some of the larger managers) continue to follow the proxy advisory firms closely, and sometimes without even reading the research.

[8] We note that there are differences between Institutional Shareholder Services ("ISS") and other proxy advisory firms such as Glass Lewis. We have tried to be specific in this letter, but the majority of the examples raised herein relate to ISS, primarily because of its dominant market share and our members' interaction with ISS. Importantly, we note that Glass Lewis only recently has begun to engage consistently with issuers and, for this reason, the interaction of the Society members with Glass Lewis as it relates to vote recommendations has been limited.

[9] See Stanford Closer Look Series (February 25, 2013) for a critique of the policy development process at ISS and Glass Lewis.

[10] The questions too often biased and the choice of responses are not appropriate for companies that complete the survey. Society comment letters and other member comment letters explain the biases, the lack of transparency and the design flaws in ISS's survey process. For example, ISS asked this question in its 2011 Policy Survey with options for a "yes" or "no" response: "In 2011,a handful of issuers required that, in order to call a special meeting, a shareholder or group of shareholders must hold the requisite ownership threshold in a net-long position. This requirement prevents shareholders seeking to call a special meeting from, for example, borrowing shares from another shareholder to satisfy the ownership criterion. Does your organization find this restriction to be sufficiently onerous to raise board responsiveness concerns?" See also, Larcker, McCall, and Brian Tayan, "And

narrow agendas of certain types of investors. Moreover, while ISS points to its survey as proof that their policies are representative, it appears that only a small number of investors respond to the surveys, and ISS has not recently provided information on the percentage of institutional clients responding.

The rise of proxy advisory firms as intermediaries in the voting process has come directly from government regulation, with ISS establishing its market position in the years following the Avon letter, and Glass Lewis formed at the time of the SEC reforms. Both firms have gained significant traction since then. As noted above, regulation from the SEC,[11] well-intentioned at the time, coupled with DOL pronouncements that have contributed to the belief for many funds that they are required to vote (which they aren't) from a fiduciary perspective. Because of the position that the DOL and the SEC have taken, they have created an opportunity (the need) for proxy advisory firms. The SEC, the DOL, and other agencies should revisit these interpretive positions.

The Society believes that proxy advisory firms should be registered with the SEC. Moreover, if government regulation continues to put an onus on institutions to vote in nearly all cases, regardless of their direct economic interest, then the government also should provide some oversight to ensure that institutions are not simply taking a lowest-cost, lowest-common-denominator approach that essentially shirks rather than embraces their fiduciary obligations. Voting has become more consequential in the life of companies, and with this comes a need for increased investor responsibility.

The SEC should reconsider whether proxy advisory firms should be exempt from the proxy solicitation rules (Exchange Act Rule 14a-2(b)(3)). This would help ensure that fiduciary obligations of good faith and due care are properly carried out by all participants in the process. Greater oversight of the entire proxy voting system would facilitate transparency, reduce conflicts of interest, and provide greater discipline in the way vote recommendations are determined, thereby ensuring that votes are cast in the financial best interests of the beneficial owners.

Our concerns about the current proxy advisory firm business, along with our suggestions for potential improvements to the current model, are described below. Our comments are organized as follows. First, we describe the influence of proxy advisory firms. Second, we discuss the harm to the integrity of the vote as a result of proxy advisory firms' factual inaccuracies, as well as the application of "one size fits all" policies applied without

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Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?", Stanford Closer Look Series, February 25, 2013.

[11] See, Proxy Voting by Investment Advisers, Investment Advisers Act Release No. IA-2106 (Jan. 31, 2003). However, the SEC did note that failure to vote would not mean breach of fiduciary duties. It stated, "We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies."

judgment about what is in the economic best interests of the shareholders of a particular company on a particular issue. Third, we set forth suggested improvements in the procedures of proxy advisory firms to: (i) increase transparency in the formulation of voting policies, (ii) mitigate the potential for factual mistakes, and (iii) give issuers more time to review voting recommendations and allow issuer comments on reports. Finally we set out proposed regulation that would require SEC oversight of proxy advisory firms and require registered investment advisors to oversee the work of such firms to ensure accuracy and transparency.

III. PROXY ADVISORY FIRMS HAVE SIGNIFICANT INFLUENCE ON VOTING OUTCOMES AND CORPORATE BEHAVIOR

The influence of proxy advisory firms is no longer questioned. Proxy advisory firms exert a significant influence on matters presented for shareholder votes. Our Survey of Society members in 2010 indicated that 50% of respondents believe that at least 20% of their shares are voted in line with proxy advisory firm recommendations. Asked differently, 82% of our respondents indicated that proxy advisory firms have a "material impact" (defined as influencing 10% or more) on the vote.

As noted above, our members witness votes cast in line with proxy advisory firm recommendations immediately when the report and vote recommendations are distributed. For example, one of our Society members stated that one year when ISS was very late in releasing its report, the member's company's vote levels were similarly delayed but running 96% in favor of directors. When ISS did release the report, the company's quorum increased from 24% to 37% (13%) within a day (the short time frame suggesting little independent deliberation by the funds using ISS) and the vote in favor of directors dropped to 80% following the ISS recommendation.

Similarly, as noted in a comment letter from IBM[12], in 2009 and 2010, an estimated 13.5% and 11.9% of the total votes cast in each year for IBM's annual meeting were cast lock-step with ISS's recommendations within one business day after the release of ISS's report. For the previous five business days, no more than 0.20% and 0.27% of the total IBM votes were cast in any one day. "**To put that into proper perspective, the IBM voting block essentially controlled by ISS has more influence on the voting results than IBM's largest shareholder. And this voting block is controlled by a proxy advisory firm that has no economic stake in the company and has not made meaningful public disclosures about its voting power, conflicts of interest or controls.**" To be clear, many companies believe that the ISS influence is far greater than the significant "one business day" impact noted above; however, that additional influence is difficult to quantify because institutional investors are not required to publicly disclose when they in essence "outsource" decision making over proxy matters to ISS or other third parties.

[12] International Business Machines, Comment Letter, *Concept Release on the U.S. Proxy Season*, October 15, 2010

One Society member faced the same shareholder proposal in 2012 and 2013, advocating an independent chair. In 2012, ISS supported the proposal, which received 39% support. In 2013, ISS changed its position to oppose the proposal, which then received 19% support. There had been no change in the company's practices that would merit such a change; rather, a mechanistic and simple-minded trigger for the ISS policy caused a 20% swing in the vote.

Another Society member stated this year that Glass Lewis controlled 8% of the vote which was evident from a recommendation made a against a proposal and the vote count coming in immediately following the issuance of the report.

The influence of proxy advisory firms is reflected not only in voting totals. The threat of an "against" or "withhold" vote by a proxy advisory firm often causes companies to adopt practices in order to ensure that they will get the favorable vote. Half of the Survey respondents noted that their companies have withdrawn or modified a proposal based on the expected voting recommendation of a proxy advisory firm and of those, 63% stated that the primary reason for the change or withdrawal was because they believed the adverse recommendation could materially impact the vote results.

Corporate boards and committees spend an inordinate amount of time ensuring their policies and practices fall neatly within proxy advisory guidelines in order to avoid unfavorable vote recommendations these firms. This is particularly the case with respect to decisions on executive compensation design, a key driver in the achievement of corporate success and long-term shareholder return.[13] Society members say that in considering executive compensation, directors increasingly ask, "What will ISS say?" And evidence suggests that this influence does not enhance shareholder value. A recently published study found, "proxy advisory firms . . . induce the boards of directors to make compensation decisions that *decrease* shareholder value." The authors write:

> We examine the shareholder value implications of outsourcing to proxy advisory firms on the recent requirement to implement Say-on-Pay. . . . [W]e confirm that proxy advisory firm recommendations have a substantive impact on SOP voting outcomes. We also find that . . . a significant number of boards of directors change their compensation programs in the time period *before* the formal shareholder vote in a manner that better aligns compensation programs with the recommendation policies of proxy advisory firms. . . . We interpret our result as evidence that boards of directors change executive compensation plans in order to avoid a negative SOP recommendation by proxy advisory firms, and thereby increase the likelihood that the firm will not fail the vote (or

[13] In a recent survey conducted by The Conference Board, NASDAQ and the Stanford Rock Center for Corporate Governance, over 70% of the director and executive officer respondents indicated that their compensation programs were influenced by the policies of and/or guidance received from proxy advisory firms during their evaluation of say-on-pay. The increase in the use of relative TSR over a 3-year time horizon as a performance metric is directly attributable to the methodology used by ISS to evaluate performance plan design.

> will garner a sufficient level of positive votes). The stock market reaction to these compensation program changes is statistically *negative*. . . . [W]e believe the most . . . plausible conclusion is that the confluence of free rider problems in the voting decision, regulation of voting in institutional investors, and the decision by the SEC to regard proxy advisor policies as appropriate for purposes of institutional investor compliance with regulation has led to policies of proxy advisory firms that induce the boards of directors to make compensation decisions that *decrease* shareholder value.[14]

As a result of the role proxy advisory firms play in formulating and establishing governance standards and the extent to which institutional fund managers follow those standards, proxy advisory firms have become the "de facto" arbiters of corporate governance practices. The New York Stock Exchange ("NYSE") Commission on Corporate Governance issued a report on September 23, 2010, that explicitly recognized the influence that proxy advisory firms have on the market. The NYSE Commission on Corporate Governance also recommends that the SEC should "require [proxy advisory] firms to disclose the policies and methodologies that the firms use to formulate specific voting recommendations, as well as material conflicts of interest, and to hold themselves to a high degree of care, accuracy and fairness in dealing with both shareholders and companies by adhering to strict codes of conduct."

IV. PROXY ADVISORY FIRMS HARM THE INTEGRITY OF PROXY VOTING BECAUSE THEY ARE SUBJECT TO CONFLICTS OF INTEREST

The Society believes that proxy advisory firm voting influence undermines the integrity of the voting system for a number of reasons: (1) proxy advisory firms are subject to conflicts of interest; (2) proxy advisory firms make factual mistakes (sometimes material or egregious) in their analysis, with the effect that their voting guidelines are erroneously applied to the company's proposal and the voting recommendation is inaccurate; and (3) proxy advisory firms have no economic interest in the shares they vote and therefore have no economic interest in the outcome.

Proxy advisory firms are subject to four types of conflicts of interest. The first occurs as a result of proxy advisory firms selling services to both institutional clients and issuers. The second conflict arises when proxy advisory firms make favorable recommendations on proposals submitted by their own investor clients. The third conflict stems from proxy advisory firms' interest in recommending certain proposals that are likely to expand their influence and future market. The fourth may arise when an owner of a proxy advisory firm takes a position on a proxy voting issue and the firm also issues a voting recommendation on that issue (this applies to Glass Lewis only).

A. Proxy advisory firms offer services to both institutions and issuers

[14] Larcker, McCall and Ormazabal at 43-45

Most notably, ISS provides advisory services to issuers on corporate governance structures or compensation plans, and then makes voting recommendations based on the same structures and plans on which it has advised. Many Society members subscribe to ISS's service in an effort to ensure they design compensation plans that will get a favorable recommendation from ISS. Indeed, some Society members report that they believe they have *no choice* but to subscribe to ISS's service in order to gain sufficient visibility into the ISS model to understand what will gain a favorable ISS recommendation.

The Society is aware that ISS believes its consulting services are walled off from vote recommendation decisions. Nevertheless, it appears that the consulting side uses the same compensation plan models that the analysts use when making voting recommendations. Accordingly, the Society does not believe this conflict can be adequately mitigated by "Chinese Wall" procedures between the consulting and voting sides of the business.

It has long been the case that Glass Lewis does not offer services or advice to issuers. However, this year, we have been made aware that Equilar, a service provider with whom Glass Lewis has a financial relationship, is marketing its service to companies that receive a negative recommendation from Glass Lewis.

One large-cap midwestern company member received a call from an Equilar sales representative two business days after Glass Lewis issued its report on the company which recommended against the say on pay proposal. The Equilar representative wanted to sell the company its consulting services so the company could learn more about the background of the Glass Lewis recommendation. The Society member asked about the basis for the number Glass Lewis had used for the CEO's compensation for 2012, as its CEO changed and GL had used a composite of the former CEO's compensation and the new CEO's compensation. It was not clear to the company how Glass Lewis had derived the number since it was about 45% higher than the amount reported in the summary compensation table for the current CEO. The Equilar sales representative was unwilling to discuss the number unless the company agreed to subscribe to the service, which was about $30,000. This same scenario was reported to us from other proxy solicitors and law firms.

The Society is very concerned about the apparent conflict of interest. As one member put it: "After all the years of GL criticizing ISS for taking consulting fees from corporate issuers, it seems that now they've adopted the same business model, except that the fees are laundered through Equilar."

The Society notes that its members increasingly engage with their shareholders on various corporate governance and compensation matters—indeed in the say-on-pay world, companies are compelled to do so. Shareholders do not charge for this consultation. The Society believes that proxy advisory firms who are acting as voting agents for the institutional investors have a conflict of interest in charging companies for consulting services that the institutional shareholders themselves are providing free of charge.

B. Proxy advisory firms make recommendations on proposals submitted by their own investor clients

Second, some proxy advisory firms make voting recommendations in favor of proposals that are being submitted by investors that are clients of the proxy advisory firm. The Society believes that the only way to mitigate this conflict is to require the proxy advisory firm to specifically disclose in their voting recommendation that the subject proposal has been submitted by a client—and for the client to disclose to the company and the other shareholders as part of its proposal in the proxy statement that the client utilizes ISS. We believe not having this information is harmful both to the other clients of ISS and to the company's other shareholders because, without this information, they have no idea of the extent of, or types of, conflicts to which the proxy advisory firm is subject. Corporate issuers and their shareholders have a right to know that they are subjected to voting recommendations that have been proposed and paid for by the proxy advisory firms' clients.

C. Proxy Advisory Firms Have an Interest in Recommending Proposals that Sustain and Expand Demand for their Services

Proxy advisory firms are in the business to make a profit. For this reason they must keep their services relevant, and necessary. This is clearer today since the say on pay vote has been mandated: "As so many predicted when Say on Pay was being debated, the outcome of mandatory Say on Pay advisory votes will be the ascendency of the proxy advisory firms' executive compensation models, whether or not the proxy advisors have any expertise or knowledge about executive compensation, whether or not their executive compensation metrics are well founded conceptually and fairly and accurately applied in practice and whether or not those metrics are at least more often than not applicable to specific companies facing specific issues in terms of management retention, management incentives and shareholder value creation."[15]

Therefore, proxy advisory firms will make recommendations that will increase demand for the services they or affiliated companies offer to the same institutional clients. In such instances, the proxy advisory firm has a specific interest in the outcome of the vote on the issue. For example, annual—rather than tri-annual—say-on-pay votes increase the frequency of proxy voting for institutional investors, thereby increasing dependence on the proxy advisory firms. As another example, MSCI, corporate parent of ISS, has an interest in generating demand for its environmental services; at the same time, ISS provides voting recommendations on shareholder proposals that advocate expanded environmental disclosures, such as the Global Reporting Initiative.

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[15] Nathan, Charles, Barrall, James D.C. and Chung, Alice, *Say on Pay 2011: Proxy Advisors on Course for Hegemony*, New York Law Journal, November 28, 2011

Furthermore, ISS 2012 voting policies for 2012 "make clear that ISS views a favorable vote of less than 70% as an indication of sufficient investor concern with a company's executive pay policies to require that either the company take what ISS considers appropriate corrective action or face a potential withhold vote recommendation for some or the company's directors. In the ISS Say on Pay universe, the new 50% passing grade for Say on Pay is now 70%."[16]

This is troubling when ISS alone has the ability to sway about 20% of the average company's vote (and Glass Lewis about 10%). A negative recommendation in year one can result in a forgone conclusion that in year two, it may take action against your board. Because they control 30%, they can recommend against say on pay and then withhold against a board the following year. Also, it sometimes happens that Glass Lewis recommends against a director with a low vote the previous year, when in fact that low vote was due to ISS against recommendations.

D. Glass Lewis is owned by an Investor That May Take a Position on a Matter for which it then Makes a Recommendation

There can be an appearance of a conflict of interest on the part of Glass Lewis because it is owned by an investor, the Ontario Teachers' Pension Plan, which itself engages in activism and takes positions in some proxy fights. While there is no evidence that OTPP exerts pressure on Glass Lewis to recommend in favor of its own agenda, the appearance of a potential conflict remains. This should be mitigated.

V. PROXY ADVISORY FIRMS HARM THE INTEGRITY OF PROXY VOTING BECAUSE THEY TAKE A "ONE SIZE FITS ALL APPROACH"

Proxy advisory firms often do not take into account the specific circumstances of the issuer, but instead follow a one-size-fits-all approach to their vote recommendations. Society members have reported situations where the proxy advisory firm recommended against a governance practice that had been approved in a prior vote by the company's shareholders--thus disregarding the will of shareholders. As a corollary, proxy advisory firms do not base their recommendations on empirical evidence of what is beneficial to the capital markets or industry.

VI. PROXY ADVISORY FIRMS HARM THE INTEGRITY OF PROXY VOTING BECAUSE THEIR REPORTS REGULARLY CONTAIN FACTUAL INACCURACIES AND GROSS ANALYTICAL ERRORS

One of the major factors undermining integrity in the proxy voting system is that the recommendations of proxy advisory firms are at times based on mistakes of fact or gross

[16] Chuck Nathan, James D.C. Barrall and Alice Chung, *Say on Pay 2011: Proxy Advisors On Course for Hegemony, New York Law Jaurnal*, (Nov. 28, 2011)

analytical errors where the drafters of the reports "just don't get it."[17] Because the services do not release their proxy reports publicly except for high fees, even after the annual meeting is concluded, and because they place strict limits on sharing of reports, it is difficult to be precise on the quantity of misinformation and clearly poor analysis produced by the firms. The Society's survey results indicate that 65% of the respondents experienced--at least once--a vote recommendation based on materially inaccurate or incomplete information, or where the proxy advisory firm reported as fact information that was incorrect or incomplete. [Q 5] One quarter of those respondents experienced inaccurate or incomplete information on several occasions. For the respondents who found inaccurate information in a vote report, the proxy advisory firm did not correct the mistake 57% of the time. Furthermore, in 44% of the instances where issuers found mistakes the proxy advisory firm reviewed its recommendations but was unwilling to change the recommendation or factual assertion. In another 22% of the instances where issuers found mistakes, the proxy advisory firm was unwilling to reconsider the recommendation at all.

This lack of accuracy harms both issuers and investors. Several Society members have informed us that in several instances their institutional investors were unaware of a mistake in a proxy advisory firm report or recommendation and stated to the issuer in private that had they known otherwise, their own votes would have been different. Other Society members from small or mid cap companies do not receive proxy advisory firm reports at all, and cannot begin to assess the basis upon which votes may have been made by their institutional investors. Moreover, Glass Lewis does not make its vote recommendations available to issuers at all—so issuers have no idea when there are mistakes in a report unless their institutional shareholders or proxy solicitors inform them. *At the very least, proxy recommendation reports should be provided to all issuers in advance to enable the issuer to check the factual accuracy of the report. Votes that are not based on actual facts are not informed votes.*

The Society believes that mistakes are made because the procedures utilized by proxy advisory firms are inadequate and not subject to review. We believe this is largely a cost and resource issue. Issuers note that the staff at proxy advisory firms seem overwhelmed during proxy season and do not appear to spend the appropriate time reviewing the issues in the context of the specific company nor in engaging in substantive dialogue with the issuer to discuss concerns they may have regarding a proposal. Moreover, much of the staff at proxy advisory firms appears to be junior, poorly paid in comparison with their investment manager clients, and to have limited experience.

To illustrate the many concerns Society members have about the processes utilized by proxy advisory firms, we have collected a number of examples from our members, which are reflected (anonymously) in the Appendix hereto. The concerns fall into the following general categories:

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[17] The best example this season was a Glass Lewis recommendation against a financial company's say on pay where it showed the company's 2012 earnings per share declining by 90% when in fact the opposite was true and the company had a very large increase in earnings per share.

Insufficient Time to Review and Comment

In the minority of situations in which a proxy advisory firm offers an issuer an opportunity to review its draft report, the review period is very short (sometimes less than 24 hours). For example, one Society member reported: "This year ISS gave us 17 hours to review and respond to their report on us this year, and 7 of those hours were between the hours of midnight on a Sunday and 7 am on a Monday." In several instances, ISS delivered the report immediately before Easter Sunday and required the issuer to respond that Monday.

No Possibility for Review at All

ISS does not permit most firms (any company not in the S&P 500 index) to review its reports before issuance.

Glass Lewis will not provide reports to any issuer **[or otherwise engage with them except in limited, typically off-season, situations.]** Companies that hire proxy solicitors usually get the report from their solicitor after Glass Lewis has distributed it to investors. Alternatively, companies can pay a fee of either $3,500 or $5,000 for its own report.

This year, the access to Glass Lewis reports has become even more difficult and costly. Proxy solicitors have been told that their under the revised terms of the subscription license they can read their clients the reports over the phone, but they can't share copies of the reports with their clients. Instead, Glass Lewis apparently expects issuers to either buy their own report, or use the Equilar "Governance Center" service that permits modeling and access to Glass Lewis reports at a cost of up to $30,000.

Infrequent Correction of Factual Errors by the Proxy Advisory Firm

Even when the issuer points out factual errors upon which the recommendation is based, proxy advisory firms do not always correct the errors – much less change the recommendation. Thus, one Society member reported in 2010 that its report from ISS calculated its CEO's compensation as cash plus a "Guaranteed Bonus" when the CEO did not receive any guaranteed bonus. When the issue was raised to ISS, the analyst said that this metric was "hard-coded" and could not be changed.

More recently, ISS and Glass Lewis have both been more receptive to change factual errors, but only when the companies know about the errors and have time to correct them. Many times it is very late in the voting process. And again, for the small and mid-cap companies that do not see reports in advance and may not use proxy solicitors, the time between discovery of error and the company meeting can be very short to nil, if at all.

Comparison to Irrelevant or Misleading Peer Groups

Inappropriate peer groups used by proxy advisory firms has been one of the most prevalent problems in recent years. Peer groups figure strongly in the two major proxy advisory firm's analysis of compensation issues, particularly say on pay. Both firms decline to use company peer groups, or to begin with those peer groups and subject them to critical analysis. Instead, they use less-costly approaches in assigning peer groups to all companies on a formulaic basis.

Both firms have changed their methodologies in the last year, at least in part in response to criticism. In both cases, there appears to be improvement, but in the case of ISS the improvement appears to be limited and its application remains unclear. For example, Apache Corp. in a supplemental filing states that ISS chose a peer group that included nine additional companies, none of which are in the oil and gas exploration and production business and are "essentially opposite parts of the energy sector, the majority of them are significantly smaller than" Apache. Even worse, one of the ISS peers had a CEO who worked only six months rather than a year, but ISS failed to annualize the compensation.

Failure to Change Recommendations after "corrections"

One company noted in a supplemental filing that one of their directors was a member of a law firm. Their initial proxy disclosed that the law firm had done business with the company, but did not disclose the amount of fees involved as it was a minimal amount ($9,000). ISS recommended investors withhold support for the director. The company called ISS and explained that $9,000 was an immaterial amount. ISS told them if the amount was not disclosed, they assumed it was a conflict. The company then filed an amendment to proxy disclosing the amount. Nevertheless, ISS did not change the withhold recommendation. All of this happened within a very short time frame since the company is not an S&P 500 company and does not get an advance copy of ISS report. While the director was ultimately elected, the company had to incur the expense to deal with ISS recommendation, which turned out to be wasted effort.

Misapplication of State law

ISS does not always apply a company's applicable state law to its voting recommendations or procedures. For example, when ISS counts votes on shareholder proposals, it does not count abstentions. Yet, state law governs how votes must be counted. Shareholders can vote for, against, or abstain, on shareholder proposals. Many investors "abstain" and this often means they do not support the proposal, yet the abstentions are not counted by ISS. The result is that a proposal will "pass" under ISS's standard but not under state law (e.g. Delaware). We think the "votes cast" threshold should include abstentions in the denominator, which would make it consistent with the Delaware standard. Even for proposals that are only advisory, the state law should trump an arbitrary standard set by a proxy advisory firm. ISS's policies should be consistent with the applicable law governing shareholder rights. Not counting abstentions tips the scale to more shareholder proposals "passing." This is important particularly because ISS has indicated that beginning next year it

will take action against directors if a shareholder proposal "passes" and the company does not enact the proposal as ISS seems fit. In effect, they could be withholding support for a director even though a majority of the shareholders have not indicated their support for the prior year's proposal.

VII. PROXY ADVISORY FIRMS HAVE NO ECONOMIC INTEREST IN THE OUTCOME OF THE VOTES THAT THEY RECOMMEND

Proxy advisory firms do not have an economic interest in the companies in which they are making voting recommendations. The delegation by investment advisors of their vote to proxy advisory firms has resulted in a divorce between the persons who make the investment decision and the persons who exercise the vote. This gap makes clear that, as the proxy voting system currently operates, voting recommendations may bear no relation to the economic performance of the company—and therefore, such voting recommendations may not, in fact, improve the performance of a company.

Because proxy advisory firms do not need to take into consideration the economic consequences of their recommendations, they do not feel compelled to specifically tailor their recommendations to the particular facts and circumstances of each issuer—and this, in turn only encourages the "one size fits all" approach currently seen in proxy advisory firm recommendations.

Thus, the fact that investment managers (with fiduciary duties) can rely on proxy advisory firms (with no fiduciary duties) not only to make voting recommendations—but also to effect the vote itself—is a disconnect in the current system that must be remedied. As further discussed below, we believe persons with the economic and fiduciary responsibilities of share ownership need to exercise more responsibility in decision-making with respect to the voting process.

VIII. PROXY ADVISORY FIRMS SHOULD BE REQUIRED TO IMPROVE THEIR PROCEDURES

Proxy advisory firms should be required to change certain of their current procedures. The Society respectfully requests that proxy advisory firms be required to:

- Establish procedures to manage conflicts of interest, and specifically disclose in their reports any and all conflicts of interest with the subject of their recommendation (e.g., as discussed above, by noting their relationship with proponents of the proposal)

- Disclose the methodologies, guidelines, assumptions or rationales used in making their recommendations, including discussion as to whether the proxy advisory firm's methodology is a "generic methodology" applied to all issuers (i.e., is not specific to the facts and circumstance of a particular issuer)

- Disclose the processes used to gather their information, including how their reviewers are trained; the number of companies each analyst reviews within a given time frame; and whether or not the recommendations go through a "second review" process by a more senior manager

- Provide ALL companies the reports in advance with at least 3 business days to review draft reports prior to their release to investors

- Disclose the processes, if any, the proxy advisory firm has established to discuss their recommendations with an issuer prior to their release; and disclose whether the firm has an "appeals" process if the issuer disagrees with the recommendation

- Include in their reports any response by the issuer regarding any factual matters or items the issuer has contested (we note this recommendation is also endorsed by the NYSE Commission on Corporate Governance), and include whether the issuer invoked an "appeal" of the recommendation (if the proxy advisory firm has such a process) and whether the proxy advisory firm revised its recommendation as a result

- Report to the SEC at the end of each proxy season the number of incidents where issuers took exception to the factual statements contained in the proxy advisors' reports or appealed the recommendation of the proxy advisory firm

- Disclose their executive compensation models and standards so that issuers do not need to purchase consulting services from a proxy advisory firm in order to determine if it will get a favorable recommendation on a stock plan

The purpose of these disclosures and procedures is intended to make the processes and methodologies utilized by the proxy advisory firm more transparent, accountable and reliable. The goal is to ensure that proxy advisory firm recommendations are undertaken with more care, accuracy and fairness.

IX. INVESTMENT ADVISORS AND PROXY ADVISORY FIRMS SHOULD BE SUBJECT TO STRICTER REGULATION

Investment advisors and other fiduciaries, such as pension plans, have a fiduciary duty to vote the shares they hold on behalf of their beneficiaries. As noted above, because of the volume of proxies needed to be voted each season, most investment managers outsource their voting responsibilities to proxy advisory firms. However, these proxy advisory firms are generally not required to also be registered with the SEC and, as they have no fiduciary duties to the shareholders on whose behalf they are making voting decisions, they have no responsibility to take into consideration how their recommendation will affect the economic value of the company's shares they are voting.

The Society believes that both investment advisors and proxy advisory firms must have an affirmative obligation to ensure that vote recommendations are based on accurate facts, are given by providers free from conflicts of interest, and are in the best interests of shareholders. While conflicts of interest may be mitigated by "Chinese Wall" procedures and adequate disclosure by both the investment advisor and the proxy advisory firm, the Society notes that issues such as lack of accuracy and accountability, which are largely resource issues, are rooted in the economics of how proxy advisory firms are compensated for their services. The Society supports proxy advisory firms having adequate staffing to enable them to undertake a thorough review of the specific facts and circumstances of individual companies--rather than merely following formulas and general guidelines. The Society believes, however, that without adequate and appropriate SEC regulation of proxy advisory services, there is no incentive for proxy advisory firms or the investment managers that hire them to provide the necessary resources to the system to ensure that vote recommendations are accurate and responsible.

A. All Proxy Advisory Firms should be required to register as Investment Advisors

An initial recommendation to improving the quality of the proxy voting system would be to require proxy advisory firms to become registered investment advisors. In this way, the practices and procedures of such firms would be subject to SEC examination. These examinations, we believe, would provide additional discipline and accountability to the system. Once registered, proxy advisory firms would need to establish to an oversight authority that they are following their procedures and would need to provide factual support for the bases of their disclosures (enhanced, as suggested above).

However, the Society is not confident that registration of proxy advisory firms, in and of itself, will solve the issues noted above, particularly the "one-size-fits-all" approach now generally taken by proxy advisory firms with respect to their recommendations and votes. The Society notes, for example, that ISS is currently registered under the Investment Advisors Act of 1940, and it is not required to perform, as part of its services, an analysis of how each proposal for which it is giving a vote recommendation will or will not benefit the company's shareholders from an economic point of view. We therefore believe registration of proxy advisory firms is just the first step needed to correct the current system.

B. The Special Treatment under the Proxy Solicitation Rules that Proxy Advisory Firms Now Enjoy is Untenable

The SEC should consider whether proxy advisory firms should also be brought within the regulatory constraints of the proxy rules themselves, through a requirement to file their recommendations as soliciting material. Many members of the Society believe that the vote recommendation is tantamount to soliciting a proxy. And while the proxy advisory firms may characterize their reports as "opinions," the fact that they issue recommendations on how to vote a particular item is no different than if a retail shareholder's broker gave a similar recommendation on how to vote.

The exemption currently available to the proxy advisory firms under Rule 14a-2(b)(3) is therefore inappropriate as applied to their business model. They characterize themselves as being in the business of giving individualized advice to those investors who subscribe to their services; however this is not true in practice since the recommendations have broad influence. The proxy advisory firms are able to function like the do because the market listens to them; Proxy advisory firm recommendations can move markets, especially in hotly contested votes, like proxy fights and mergers/acquisitions. Therefore, having made themselves an integral part of the proxy voting process, they should be required to abide by the same rules as all the other participants.[18]

C. Investment Advisors Relying on Proxy Advisory Firms Should Oversee Their Recommendations and Analysis

In addition to the registration of proxy advisory firms, any investment advisor or other fiduciary that relies upon or uses a proxy advisory firm should be required to exercise appropriate oversight of the proxy advisory firm and its recommendations. The entity that has fiduciary duties to its clients (who are the beneficial owners of the issuer's stock) should, at a minimum, ensure that the proxy advisory firm (who in fact is acting as the investment manager's agent) has processes and procedures in place that are responsible, auditable, accountable and transparent with respect to its voting recommendations.

We therefore propose that the proxy advisory firm that is used by an investment manager be audited periodically by the investment manager to assess the quality of the votes cast on its behalf, including ensuring that the votes cast were consistent with the policies of the institutional advisor/fiduciary (if different from the proxy advisory firm).

In addition, each investment manager or other fiduciary that utilizes the services of a proxy advisory firm should be required to disclose to its clients: (i) the name(s) of the proxy advisory firm it has engaged, and (ii) the extent to which the investment advisor/fiduciary has followed or not followed the recommendations of the proxy advisory firm.

Most importantly, we would propose that each investment manager or other fiduciary that utilizes the services of a proxy advisory firm be required to establish procedures to ensure that by following the voting recommendation of the proxy advisory firm with respect to a particular company, the investment manager was acting in the best economic interests of the shareholders of such company. Only in this way will the total disconnect that currently exists between those who manage the economics of share ownership and those who determine the vote associated with share ownership be addressed and corrected.

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[18] Wachtell Lipton Comment Letter to SEC RE: Concept Release on the US Proxy System (Release No. 34-62495: IA-3052; IC-29340) dated October 19, 2010 at 7.

The purpose of the procedures and disclosures suggested above is not intended to limit the ability of investment managers and other fiduciaries in retaining the services or proxy advisory firms. Rather, the additional procedures being proposed are intended to provide discipline, accountability and oversight for the process by which proxy advisory firms develop and vote their recommendations, and the additional disclosures being proposed are intended to provide appropriate and necessary information to the relevant stakeholders (issuers and their shareholders, fund participants of investment managers, and clients of proxy advisory firms) of these processes and of any conflicts of interest that may exist between participants in the process.

The processes and disclosures proposed above may become more applicable in light of regulations proposed on October 21, 2010 by the Department of Labor which, if adopted, would substantially broaden the definition of the term "fiduciary" under the Employee Retirement Income Security Act of 1974 ("ERISA"). One result of the broadened definition may be the inclusion within such term of proxy advisory firms, which firms would then become subject to the rigorous standards of conduct with which plan fiduciaries are charged under ERISA. Even if proxy advisory firms are not themselves brought within the definition of "fiduciary" under the proposed regulations, it is clear from the Preamble of the proposed rules that the DOL views investment advice as advice relating to "other property of the plan" including "advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)."[19] We note that this rule proposal was withdrawn and is expected be re-proposed this year.

Consistent with the DOL's views as articulated in the proposed rules, the Society believes it is clear that investment managers need to be more responsible and take a more active role in supervising the voting recommendations of proxy advisory firms. Consistent with their fiduciary duties, investment managers need to be able to demonstrate that the vote cast in respect of a particular proposal for a particular company supports and helps maximize the economic value of the shares being voted. Only in this way will the disconnect between economic and voting power that currently exists in the proxy voting system be remedied.

Summary

As stated so aptly by Larcker, McCall and Ormazabal above: "The obvious question that remains to be answered is whether or not the confluence of government regulations, the outsourcing of recommendations the proxy advisory industry, and responses by boards of directors to these recommendations, produces an increase in shareholder value as anticipated by government regulators (SEC, 2003)."[20] We believe that the answer is no. But with appropriate oversight of proxy advisory firms, through additional regulation of both the firms and the investment managers that engage them, the system will be significantly improved, more transparent, and more accountable.

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[19] Federal Register, Vol. 75, No. 204, Oct. 22, 2010 at 65266.
[20] Larcker study at 4.

We appreciate the opportunity to have commented on this important proposal and would be happy to provide you with further information to the extent you would find it useful.

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STANFORD CLOSER LOOK SERIES
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And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?

By David F. Larcker, Allen L. McCall, and Brian Tayan
February 25, 2013

THE ROLE OF PROXY ADVISORY FIRMS

Proxy advisory firms are independent, for-profit consulting companies that provide research and voting recommendations on corporate governance matters brought before investors at shareholder meetings. These matters include the election of the board of directors, approval of equity-based compensation programs, advisory approval of management compensation, and other management- and shareholder-sponsored initiatives regarding board structure, compensation design, and other governance policies and procedures.

There are many reasons why investors might choose to consult with third-party advisors when voting their position on these matters. Institutional investors are generally required by the Securities and Exchange Commission to vote all matters on the corporate proxy and disclose their votes to beneficial owners of their funds. Given the size and diversity of their holdings, it might be impractical for professional investors to have a thorough understanding of all items brought before them. Small investors, in particular, might not employ sufficient analytical staff to review all proposals in detail. For these reasons, reliable and valid third-party recommendations can contribute to a well-functioning market by improving information flow between issuers and investors leading to better decisions on compensation and corporate governance.

The proxy advisory industry in the United States is currently dominated by two major firms: Institutional Shareholder Services (ISS) and Glass Lewis & Co., whose clients manage $25 trillion and $15 trillion in investment assets, respectively. The research literature demonstrates the influence that these firms have over voting outcomes. Bethel and Gillan (2002) find that a negative recommendation from ISS on a management proposal can sway between 13.6 percent and 20.6 percent of the vote.[1] Cai, Garner, and Walking (2009) find that a negative ISS recommendation can influence 19 percent of the vote.[2] Research evidence also demonstrates the influence that proxy advisory firms have over the design of corporate governance policies. In a recent survey conducted by the Conference Board, NASDAQ and the Stanford Rock Center for Corporate Governance, over 70 percent of directors and executive officers report that their compensation programs are influenced by the policies or guidelines of proxy advisory firms.[3]

For these reasons, the quality of proxy advisory recommendations is critical to ensuring that shareholders, corporate officials, and regulators make appropriate decisions regarding compensation and governance policies. The clients of proxy advisory firms need to be diligent in their evaluation of the policies of these firms to ensure that these policies are "accurate" and aligned with their interest to maximize long-term shareholder value.[4] Accurate recommendations are those that successfully differentiate between good and bad future outcomes. Negative recommendations from proxy advisory firms should be correlated with negative future outcomes (e.g., poor future stock performance, increased risk of accounting restatement, etc.) and positive recommendations correlated with positive future outcomes.

POLICY DEVELOPMENT PROCESS

To assess the accuracy of proxy advisory firm policies, we can evaluate both the process by which they are developed and their consistency with neutral,

rigorous empirical research. Glass Lewis provides little information to the general public on the development of their voting policies. According to a Glass Lewis discussion paper:

> *Glass Lewis' policies, tailored for each market, are formulated via a bottoms-up approach that involves discussions with a wide range of market participants, including investor clients, corporate issuers, academics, corporate directors and other subject matter experts, among others. The process takes into consideration relevant corporate governance standards, company, local regulations and market trends. Policy changes and report enhancements are driven by such discussions, as well as through consultations with the Glass Lewis Research Advisory Council.*[5]

Moreover, Glass Lewis does not provide clarifying detail on how general corporate governance concepts and standards are translated into codified policy. Without this information, it is difficult for investors to assess whether the process used by Glass Lewis leads to accurate recommendations.

Institutional Shareholder Services discloses more extensive information than Glass Lewis does about the firm's policy development process. According to their website:

> *ISS is committed to openness and transparency in formulating its proxy voting policies and in applying these policies to more than 40,000 shareholder meetings each year.... Our bottom-up policy formulation process collects feedback from a diverse range of market participants through multiple channels: an annual Policy Survey of institutional investors and corporate issuers, roundtables with industry groups, and ongoing feedback during proxy season. The ISS Policy Board uses this input to develop its draft policy updates on emerging governance issues each year. Before finalizing these updates, we publish draft updates for an open review and comment period.*[6]

Patrick McGurn, executive director at ISS, contends that the firm's "multi-tiered process" helps to mitigate "unintended consequences" by incorporating "fact-specific feedback" to shape final policies.[7] Martha Carter, director of research at ISS, believes that "our commitment to this approach enhances the value of the research we deliver to clients."[8]

However, there are several issues in ISS' approach which raise questions about the accuracy of its recommendations. First, the ISS data collection process relies on a very small number of participants. For example, ISS' most recent policy survey received responses from only 97 institutional investors.[9] This figure is down 69 percent from just four years ago.[10] A sample of this small size is unlikely to identify compensation and governance policies that should be applied uniformly to all publicly traded corporations.[11] The decline in respondents is particularly troubling because it suggests that ISS is not successful in contacting participants or in convincing them of the value of their participation. It also raises the concern that more strident viewpoints might be over-weighted in the sample if strongly opinionated investors are more likely to participate.

Second, the composition of the respondent pool that ISS does reach is not well disclosed. Although ISS provides descriptive statistics of the types of institutions that participate in the survey, the investment objectives of these investors is not clear (see Exhibit 1). This matters because assessing policy outcomes will differ depending on whether they are tailored to *shareholder*-centric investors or *stakeholder*-centric investors. As it is, there is no way to determine whether ISS' response pool is representative of shareholder groups broadly or instead reflects the opinions of a narrower set of activists, hedge funds, passive investors, etc. (In the survey, ISS asks respondents whether their organizations are "mission-based" but does not disclose the resulting statistics. See the bottom of Exhibit 1)

Third, the survey suffers from design errors that are likely to confuse and/or bias respondents. For example, the ISS survey is flawed in how it frames certain questions and offers response choices (see Exhibit 2). These errors are important because they make survey results difficult to interpret and even more difficult to generalize into voting recommendations. Furthermore, the ISS survey does not seek to establish the precise thresholds or conditions under which a recommendation "for" or "against"

will be triggered. Instead, the ISS survey uses vague qualifying words such as "excessive," "problematic," and "significant" whose exact meanings are open to interpretation by the respondents. As such, it is difficult to understand how responses to these questions ultimately lead to concrete voting policy decisions (e.g., a negative say-on-pay recommendation will be triggered if CEO compensation levels are above [*some specific threshold*]).

Fourth, it is unclear how ISS incorporates the feedback that it receives during the open comment period to finalize voting policies. For example, ISS recently proposed a draft rule that would recommend investors vote against directors of a company that failed to act on a shareholder proposal receiving majority support during the previous year. ISS justified the rule by citing its policy survey results which found that "86 percent of institutional investor respondents expect that the board should implement a shareholder proposal that receives support from a majority of shares cast." It claimed that the rule would "strengthen its policy to hold directors accountable for failure to respond."[12] In a comment letter, Pfizer opposed the change and pointed out that the rule can run counter to a board's fiduciary duties:

> *The Policy runs the risk that Boards would be coerced to abdicate their fiduciary duties, which do not disappear or become less significant when a majority of the votes cast at a meeting support a particular proposal. Boards should not feel compelled to act where they believe that such action is not in the best interests of the company. It certainly would make sense to disclose the Board's rationale, but an automatic vote against all directors is inappropriate and inadvisable.*[13]

Similar arguments were made by executives at Ball Corporation, Eli Lilly, FedEx, Honeywell, and Principal Financial Group and by the Business Roundtable and the National Association of Corporate Directors (NACD).[14] Still, ISS adopted the rule without specifying the conditions under which it would defer to a board's judgment of what constitutes a correct action given its fiduciary duties.[15]

Finally the linkage between the opinions proxy advisors collect through the solicitation process and the policies ultimately enacted is unclear. ISS solicits investor and issuer sentiment on general concepts relating to board structure, compensation, and governance matters and then somehow translates this into codified policies. For example, the firm's most recent policy survey asked institutional investors their view on the practice of allowing executives and directors to pledge company stock as collateral for a margin loan. Forty-nine percent responded that any pledging of shares is "significantly problematic;" 38 percent responded that pledging is concerning if it involves a "significant amount of shares;" and 13 percent responded that it is not a concern (see Exhibit 2 for the exact question and responses).[16] ISS cited these results in its 2013 policy document which was updated to recommend that investors vote against the election of directors of companies whose executives or directors have pledged shares, depending on the "magnitude of aggregate pledged shares in terms of total common shares outstanding or market value or trading volume."[17] Left unspecified is the threshold above which pledged shares will trigger an "against" or "withhold" vote. ISS did not solicit this information in the policy survey, nor did it publish the results of rigorous empirical testing to demonstrate the levels at which executive or director pledging of shares has been reliably shown to reduce shareholder returns or amplify enterprise risk. Without rigorous and transparent research, how can ISS ensure that its final policies are anything other than arbitrary?

More broadly, ISS and Glass Lewis should demonstrate that they engage in testing to ensure that their final policies are accurate—i.e., that they produce outcomes that are, on average, superior to the outcomes observable under alternative policies or no policy at all. Since proxy advisory firms have the data used to make their recommendations, it should be easy for them to back-test results to verify that their past voting recommendations were correct.

A review of the research literature uncovers numerous instances where proxy advisory policies are either in conflict with research results or not directly supported by them. For example, research suggests that proxy advisory firm voting recommendations

for management "say on pay" are not value enhancing but instead value destroying.[18] Similarly, research suggests that proxy advisory firm voting recommendations for stock option exchanges also decrease shareholder value.[19] To our knowledge, there is no research evidence to support ISS criteria for equity compensation plans or the firm's calculation of proprietary metrics such as the "annual burn rate" and "shareholder value transfer" which are used to determine whether shareholder dilution is excessive. In contrast, proxy advisory firm guidelines on other matters, such as certain anti-takeover protections, do have empirical support.[20]

WHY THIS MATTERS

1. ISS claims that its process for developing proxy voting guidelines is "open and transparent." However, a careful examination does little to clarify the information they rely on in deciding to adopt a policy. How exactly do ISS and Glass Lewis determine that a policy is "correct?" How do they determine that a specific policy is in the best interest of shareholders?
2. Proxy advisory firms obtain feedback from a diverse set of market participants in the policy formulation process. However, the most recent ISS survey contained responses from only 97 institutional investors. Who participates in the policy development process with both ISS and Glass Lewis? How do we know that these participants validly represent the objectives and opinions of all market participants?
3. Investors and corporate issuers often have very different perspectives on corporate governance matters. How does ISS weigh these competing perspectives? Do they "favor" the investor perspective over the issuer perspective? If so, when is this approach justified and when is it not?
4. Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisors? Why don't ISS and Glass Lewis disclose the specific research (either that they have conducted or conducted by third-parties) that justifies each of their recommendations? ■

[1] Jennifer E. Bethel and Stuart L. Gillan, "The Impact of Institutional and Regulatory Environment on Shareholder Voting," *Financial Management* (2002).

[2] Jie Cai, Jacqueline J. Garner, and Ralph A. Walking, "Electing Directors," *Journal of Finance* (2009).

[3] The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (2012). Available at: http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

[4] In a recent speech, former SEC Commissioner Daniel M. Gallagher warns of the potential problems that can arise from overreliance on the advice of proxy advisory firms. In particular, he emphasizes the need to ensure that their policies are accurate and free from conflict of interest: "It is important to ensure that advisers to institutional investors... are not over-relying on analyses by proxy advisory firms. We learned a significant lesson about overreliance on the diligence of others in the run up to the financial crisis, as investors and regulators relied on credit rating agencies with disastrous results. As with credit rating agencies, it is important for policymakers to understand, evaluate, and if necessary address the practices and business models of proxy advisory firms. Of particular interest should be accountability for accuracy as well as potential conflicts of interest...." See: Daniel M. Gallagher, "Remarks before the Corporate Directors Forum," Jan. 29, 2013, Available at: http://www.sec.gov/news/speech/2013/spch012913dmg.htm.

[5] Glass Lewis & Co., "Discussion Paper—An Overview of the Proxy Advisory Industry. Considerations on Possible Policy Options," (Jun. 25, 2012). Available at: http://www.glasslewis.com/assets/uploads/2012/12/062512_glass_lewis_comment_esma_discussion_paper_vf.pdf.

[6] ISS, "Policy Formulation and Application." Available at: http://www.issgovernance.com/policy/process.

[7] Patrick McGurn, participant in: US Chamber of Commerce, "Examining the role of Proxy Advisory Firms," (Dec.5, 2012). Available at: http://www.uschamber.com/webcasts/examining-role-proxy-advisory-firms.

[8] ISS, "Institutional Shareholder Services Releases 2013 Proxy Voting Policies," (Nov. 16, 2012).

[9] ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

[10] RiskMetrics Group, 2008-2009 RiskMetrics Group Policy Survey: Summary of Results (October 2008).

[11] ISS, Proxy Advisory Services (2013). Available at: http://www.issgovernance.com/proxy/advisory.

[12] ISS, "Board Response to Majority-Supported Shareholder Proposals (U.S.). Available at: http://www.issgovernance.com/BoardResponseMajorityShareholderProposals2013.

[13] Letter from Matthew Lepore, Vice President and Corporate Secretary, Chief Counsel, Pfizer Inc (November 7, 2012). Available at: http://www.issgovernance.com/files/PfizerInc..pdf.

[14] ISS, 2013 Draft Policies for Comment. Available at: http://www.issgovernance.com/policycomment2013.

[15] Following the open comment period, ISS amended the final rule to include the condition that "less than full implementation will be considered on a case-by-case basis;" however, this qualification raises more questions than it answers on how ISS will decide whether to defer to the board's judgment. See: ISS, U.S. Corporate Governance Policy: 2013 Updates (Nov. 16, 2012).

[16] ISS, 2012-2013 Policy Survey Summary of Results (September 2012), loc. cit.

[17] ISS, 2013 Updates, loc. cit.

[18] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisory Say-on-Pay Voting Policies," Rock Center for Corporate Governance at Stanford University working paper (May 2012). Available at: http://ssrn.com/abstract=2101453.

[19] David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Proxy Advisory Firms and Stock Option Exchanges: The Case of Institutional Shareholder Services," Stanford Rock Center for Corporate Governance at Stanford University working paper (Apr. 15, 2011). Available at: http://ssrn.com/abstract=1811130.

[20] Proxy advisory firm opposition to staggered boards is supported by John Pound, "The Effects of Antitakeover Amendments on Takeover Activity: Some Direct Evidence," *Journal of Law and Economics* (1987); Lucian Arye Bebchuk, John C. Coates IV, and Guhan Subramanian, "The Powerful Antitakeover Force of Staggered Boards: Theory, Evidence, and Policy," *Stanford Law Review* (2002); and other papers. Proxy advisory firm opposition to dual class shares is supported by Ronald W. Masulis, Cong Wang, and Fei Xie, "Agency Problems at Dual-Class Companies," *Journal of Finance* (2009).

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The Stanford Closer Look Series is a collection of short case studies that explore topics, issues, and controversies in corporate governance and leadership. The Closer Look Series is published by the Center for Leadership Development and Research at the Stanford Graduate School of Business and the Rock Center for Corporate Governance at Stanford University. For more information, visit: http://www.gsb.stanford.edu/cldr.

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EXHIBIT 1 — ISS POLICY SURVEY: RESPONDENT PROFILE (2012-2013)

More than 370 total responses were received. A total of 97 institutional investors responded. Approximately 71 percent of investor respondents were located in the United States, with the remainder divided between U.K., Europe, Canada, and Asia-Pacific. 237 corporate issuers responded, with 79 percent of them located in the United States and the remainder divided between U.K., Europe, and Canada.

Institutional Investor	
Investment manager or asset manager	62%
Government or state sponsored pension fund	8%
Mutual fund or mutual fund company	8%
Commercial or investment bank	4%
Insurance company	3%
Foundation or endowment	2%
Labor union-sponsored pension fund	2%
Alternative asset management	1%
Investor industry group	1%
Private bank, wealth management, or broker	1%
Other	8%

Size of Organization	Institutional Investor	Corporate Issuer
Over $100 billion	32%	5%
$10 billion - $100 billion	22%	29%
$1 billion - $10 billion	30%	31%
$500 million - $1 billion	4%	7%
$100 million - $500 million	6%	7%
Under $100 million	5%	2%
Not applicable	2%	19%

Notes: Size of institutional investors measured by equity assets under management or assets owned; size of corporate issuers measured by market capitalization.

Results not reported to the question: "Is your organization a mission-based or socially-responsible investor?"

Results also not reported to the question: "Is your organization a UN Principles for Responsible Investing (PRI) investor signatory?"

Source: ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

EXHIBIT 2 — EXAMPLES OF QUESTION DESIGN FLAWS

The ISS 2012-2013 Policy Survey contains three types of question design flaws:

1. The assumptions that frame some questions are not adequately defined.
2. Some questions contain leading or biasing comments.
3. Some questions contain response selections that bind respondents to multiple answers or to answers that might not match their opinion.

Consider the following questions.

Question 14. Currently, ISS has a policy on overboarded directors (directors serving on an excessive number of boards) which counts only public company boards. Should ISS include other significant directorships in its policy (e.g., private companies, national non-profit organizations, subsidiary company boards)?	Institutional Investors	Corporate Issuers
Yes	59.0%	17.8%
No	23.1%	71.3%
It depends (please specify)	17.9%	10.9%

Design flaws:

- The policy on "overboarded directors" is referred to but not provided.
- The term "excessive" is not quantified.
- The question binds respondents to multiple responses. E.g., an investor who believes that private company directorships should be included in the policy but not nonprofit directorships is not permitted to express this opinion.

Pay for Failure. Question 22. During the past decade, shareholder have witnessed a series of CEOs who have received sizable termination packages at a time of significantly lagging shareholder returns. Does your organization consider the following actions to be problematic in such a scenario?	Institutional Investors		Corporate Issuers	
	Yes	No	Yes	No
A severance settlement when the executive is stated to be retiring or resigning	81.3%	18.8%	40.3%	59.7%
Immediate acceleration of all unvested equity upon termination without cause	84.4%	15.6%	44.8%	55.2%
Cash severance exceeding 3x base salary and target bonus	93.8%	6.2%	81.1%	18.9%
Cash severance exceeding 1x base salary and target bonus	35.9%	64.1%	11.0%	89.0%
New severance agreement entered immediately prior to departure	89.6%	10.4%	61.7%	38.3%
Large pension / SERP payouts	80.6%	19.4%	32.5%	67.5%

Design flaws:

- The heading "pay for failure" biases respondents that the termination packages in question are not merited.
- The terms "sizable packages" and "significantly lagging returns" are not quantified.
- The term "problematic" is vague. It could be interpreted to mean anything from a minor annoyance to a critical issue.
- The question is not clearly tied to a policy decision.

EXHIBIT 2 — CONTINUED

Pledging of Shares. Question 24. Some shareholders have raised concerns about the practice of executives or directors pledging company stock (e.g., shares used as collateral for margin accounts or other loans). What is your organization's view of suck practice?	Institutional Investors	Corporate Issuers
Any pledging of shares by executives or directors is significantly problematic	49.2%	45.0%
Concerning if it involves a significant amount of shares (e.g., > 500,000 or a value exceeding 10% of the company's market value)	37.7%	34.9%
Not a concern	13.1%	20.1%

Design flaws:

- The first sentence of the question biases respondents that pledging is negative.
- The scale is not properly structured. It does not sufficiently allow for moderate opinions.
- The second response combines different conditions. 500,000 shares is very different from shares representing 10% of a company's market value.
- The question is not clearly tied to a policy decision.

Question 25. A number of issuers have adopted compensation metrics that are tied to non-financial performance such as environmental goals or regulatory compliance. Similarly, some shareholder proponents submit proposals requesting adoption of environmental or other sustainability-related metrics for executive compensation. Which of the following statements best represents your organization's view on this topic?	Institutional Investors	Corporate Issuers
The decision to use environmental or other sustainability-related metrics is best left to the members of a compensation committee. Calls for use of such metrics constitute undue micromanagement of the executive pay process	27.9%	72.5%
Calls for a board to adopt environmental or other sustainability-related metric may be appropriate at companies where there have been significant problems in the past. A case-by-case approach is best suited to determining if the use of such metrics would benefit shareholders.	35.3%	19.6%
Environmental or other-sustainability-related compensation metrics are appropriate tools for boards to use to focus executives on managing significant risks. Use of such relevant non-financial metrics in pay programs would benefit shareholders.	32.4%	5.8%
Other (please specify)	4.4%	2.1%

Design flaws:

- The question biases respondents that the adoption of these performance metrics is positive.
- The choices bind respondents to multiple answers. It is possible to agree with the first sentence of each but not the second.
- The question is not clearly tied to a policy decision.

Source: ISS, 2012-2013 Policy Survey Summary of Results (September 2012).

MERCATUS
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HOW TO FIX OUR BROKEN PROXY ADVISORY SYSTEM

James K. Glassman and J. W. Verret

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Release date: April 16, 2013

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ABSTRACT

A RULE ENACTED by the Securities and Exchange Commission in 2003 required institutions to adopt and disclose policies for proxy voting that were intended to minimize conflicts between the institutions' interests and those of their shareholders. An SEC staff interpretation of that rule led to a result almost the opposite of the ruling's intent. Institutions could easily protect themselves from legal liability by shifting responsibility to proxy advisory firms, which acquired increasing power over corporate governance, to the detriment of shareholders. The rule resulted in outsourcing decision making to advisors with little particularized knowledge and no incentive to maximize value. The proxy advisory firms themselves face the same conflicts of interest that the rule was intended to minimize. The problem is compounded by a market for proxy advice that is dominated by two firms. To fix this broken system, it is necessary to return the responsibility to determine the need for a vote to shareholders and directors.

JEL codes: G1, G2, G3 K2, and L2

Keywords: proxy advisory firms, shareholders, hedge funds, mutual funds, Institutional Shareholder Services, Securities and Exchange Commission

I. BACKGROUND

A DECADE AGO, the Securities and Exchange Commission (SEC) voted to require that every mutual fund and its investment adviser disclose "the policies and procedures that [they use] to determine how to vote proxies" —matters put to a vote by the public companies whose stock the fund holds—and to disclose votes annually.[1]

The idea behind Rule 206(4)-6 and Rule 30b1-4, which were enacted on August 6, 2003,[2] was to "encourage funds to vote their proxies in the best interests of shareholders" and to avoid conflicts of interest between those shareholders and the fund's "investment adviser, principal underwriter, or certain of their affiliates."[3]

The SEC rule followed changes at the US Department of Labor (DOL) in the 1980s mandating that ERISA pension plan fiduciaries—such as union, corporate, and other officials who control or manage a plan's assets—vote the plan's shares on the basis of active analysis, regardless of whether or not the fiduciary was certain that expending time and effort to analyze how to vote would create value for a fund.[4]

The vast majority of shareholder elections are uncontested, and the vast majority of shareholder proposals are unsuccessful. As a result, it has been argued that actively participating in shareholder elections, shareholder proposal votes, or other proxy votes may not be worth the effort for pension or mutual funds in lieu of other strategies (such as abstaining or passively voting in favor of management

1. SEC, "Securities and Exchange Commission Requires Proxy Voting Policies, Disclosure by Investment Companies and Investment Advisers," press release, January 1, 2003, http://www.sec.gov/news/press/2003-12.htm.
2. "SEC Brings Second Case Alleging Improper Proxy Voting by an Adviser," Ropes & Gray, May 20, 2009, http://www.ropesgray.com/intech/.
3. SEC, "Proxy Voting Policies."
4. "ERISA 3(16) Fiduciary Plan Administrator Overview," ING Financial Services, accessed April 4, 2013, ing.us/file.../5399/fiduciary_erisa_3_16__plan_admin_overview.pdf.

recommendations unless specific circumstances require more scrutiny).[5] But the Department of Labor ruled otherwise. In a key 1988 document called the "Avon Letter," DOL stated that "the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock."[6] The SEC eventually followed suit.

A few months after the adoption of the SEC's rule, one of the SEC commissioners, Paul Atkins, expressed his relief that "the rule did not impose a 'one-size-fits-all' requirement for the written proxy voting procedures. Instead, we left advisers with the flexibility to craft suitable procedures."[7]

Unfortunately, the rule became a classic case of unintended consequences. Many institutional investors largely outsourced their shareholder voting policies to a proxy advisory industry that relies on precisely the type of "one-size-fits-all" policies that were intentionally excluded from the original regulation because of objections by commissioners. The SEC staff interpretation of the rules on proxy voting have led to the opposite result of what many of its supporters intended. Instead of eliminating conflicts of interest, the rule simply shifted their source. Instead of encouraging funds to assume more responsibility for their proxy votes, the rule pushes them to assume less. Instead of providing informed, sensitive voting on proxies, the incentive has been to outsource decision making to two small organizations that most investors have never heard of. These two firms have emerged as the most powerful force in corporate governance in America today, shaping the way that mutual funds and other institutions cast votes on proxy questions posed by about 5,000 US public companies.

The larger of the firms, Institutional Shareholder Services (ISS), was founded in 1985. When the Department of Labor issued its new mandate a few years later, ISS made a specialty of advising institutional investors on how to comply with it,[8] and the firm has since profited from the demand created for its services by the government's requirements.

5. David Yermack, "Shareholder Voting and Corporate Governance," *Annual Review of Financial Economics* 2 (December 2010): 30, doi:10.1146/annurev-financial-073009-104034. Passive voting strategies are distinguished from abstentions. Companies need to obtain a quorum of shareholder participation even in an uncontested vote to have a successful board election, merger approval, etc., and so passively voting shares can still be a valuable exercise.

6. Allan Liebowitz, letter to Helmuth Fandl, February 23, 1988, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 17, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

7. "Speech by SEC Commissioner: Remarks at the Investment Counsel Association of America," Commissioner Paul S. Atkins, SEC, April 11, 2003, http://www.sec.gov/news/speech/spch041103psa.htm.

8. "25for25: Observations on the Past, Present, and Future of Corporate Governance In Celebration of ISS' 25th Anniversary," ISS (2011): iv, http://www.rhsmith.umd.edu/cfp/pdfs_docs/commentary/ISS.pdf.

Proxy season is now underway. More than half of US annual meetings, where proxies are tallied, take place in April, May, or June.[9] In 2010 the SEC issued a "concept release" that called for an examination of the entire US proxy system, including "the role and legal status of proxy advisory firms."[10] No action has been taken on the release, but with a new SEC chair moving into office a reexamination of the issue could be imminent. This report lays the groundwork for that consideration. What remains to be seen is whether the SEC will address a system that is badly broken and, most of all, hurts the small shareholders it is supposed to help.

The authors do not hastily rush for a regulatory solution to all corporate governance challenges. We recognize that on most issues shareholders have a plethora of nonregulatory tools available, including self-funded proxy fights, taking short positions, pricing corporate governance quality at firms into trading activity, and suing a company in state court for breach of fiduciary duty by a director or officer.

We want to be clear. Good corporate governance is crucial to the long-run success of any publicly traded company, and even the most aggressive defenders of capitalism agree that the participation of shareholders in proxy voting on governance issues can be an appropriate practice. In a recent report, the US Chamber of Commerce lauded "policies that promote effective shareholder participation in the corporate governance process. Strong governance is a critical cornerstone for the healthy long-term performance of public companies and their positive promotion of long-term shareholder value."[11]

But for the problem created by government rules that have enshrined two small proxy advisory firms, shareholders do not have a nonregulatory solution. We argue that as long as proxy advisors hold regulatory preferences and a regulatory mandate that funds purchase their services, more regulatory attention to the conflicts posed by these proxy advisors is wise. The remainder of this paper will sketch the specific problems that should be addressed and our approach to resolving them.

9. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 3, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.

10. Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010). Comments on the concept release can be found at http://www.sec.gov/comments/s7-14-10/s71410.shtml.

11. US Chamber's Center for Capital Markets Competitiveness, "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," March 2013, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

II. THE SOURCES OF ADVISORS' POWER

OF THE TWO firms that dominate the proxy-advisory business, the larger by far is ISS with a 61 percent market share.[12] The second is Glass, Lewis & Co., LLC, with a market share of about 36 percent.[13] ISS is owned by MSCI Inc., a New York Stock Exchange–listed company that maintains dozens of stock and bond indices and provides portfolio management analytics for investment firms. Glass Lewis is owned by the Ontario Teachers' Pension Plan Board, which manages a fund with more than $100 billion in assets. These two principal proxy advisors have inherent conflicts not simply in their ownership but also in the services they provide to clients. Proxy advisors also have shown a tendency toward ideological bias in their recommendations, especially in areas that involve labor union power, executive compensation, and the environment.

The power of the two firms has increased in recent years for several reasons. First, mutual funds have become a larger force in investing, especially with the rise of defined-contribution pension plans. Institutional stock ownership has risen from 47 percent of assets of the 1,000 largest public corporations in 1987 to 76 percent just 20 years later.[14] Overall, mutual fund assets have risen nearly 30-fold since 1987, and total shareholder accounts have quintupled.[15]

Second, shareholder activism by well-connected groups—particularly unions and environmental organizations—has sharply increased. In addition, the Supreme Court's recent decision in *Citizens United v. FEC*[16] opened up new avenues for corporate spending in elections, spurring current debates about whether shareholders should be able to approve such expenditures and whether corporations should be

12. A study by the US Government Accountability Office in 2007, "Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting," found that between them, ISS and Glass Lewis had more than 2,000 institutions (mutual funds and other financial firms) as clients, with $40.5 trillion in equity assets. Institutions served by the next three largest proxy-advisory firms had just $1.1 trillion in assets. See Government Accountability Office, *Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting, a Report to Congressional Requesters*, GAO-07-765 (Washington, June 2007): 13, http://www.gao.gov/new.items/d07765.pdf.

13. Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business & Finance* 14 (Spring 2009): 395. The author, an associate professor at New York Law School, attached the comment to a letter filed with the SEC on October 20, 2010. See http://www.sec.gov/comments/s7-14-10/s71410-183.pdf.

14. "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15-16, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

15. "2012 Investment Company Fact Book: A Review of Trends and Activity in the U.S. Investment Company Industry," Investment Company Institute (2012): 134, http://www.ici.org/pdf/2012_factbook.pdf.

16. 558 U.S. 310 (2010).

17. James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" (Fall 2012): 19, http://proxymonitor.org/pdf/pmr_04.pdf.

required to disclose them.[17] New rules either proposed or approved by the SEC are making it even easier for such measures to be added to proxy ballots by shareholders.[18]

As a result, proxy proposals by shareholders are on the rise, according to a November 2012 "Shareholder Activism Insight Report" from the law firm Schulte, Roth & Zabel, polling corporate executives and shareholder activists:

> Corporate executives should expect to see increasing opposition from shareholders during next spring's proxy season, according to the 78% majority of overall respondents. Using poor financial performance and the need for management or operational change as motivation, hedge funds, pensions and unions will continue the growth of shareholder activism. A significant increase in shareholder proposals will result, according to 84% of respondents.[19]

The principal legislation that resulted from the 2008–09 crisis, the Dodd-Frank Wall Street Reform and Consumer Protection Act,[20] adds to the importance of proxy voting by mandating that companies with a public float greater than $75 million conduct periodic (in most cases, annual) "Say-on-Pay" (SoP) votes.[21] While those votes are nonbinding, they are taken seriously by corporate directors, not least because lawsuits could ensue if shareholder preferences are ignored. The SoP mandate was expanded this year to include 1,500 smaller reporting companies.[22]

More institutional ownership, a trend toward activism, and the Dodd-Frank legislation have all enhanced the power of proxy advisors. But an even more important factor was how the original 2003 SEC rule was interpreted by SEC staff. In a staff letter responding to a request from Egan-Jones, a small proxy firm, the SEC advised on May 24, 2004:

> An investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an

18. See Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59 (2010): 872–77, listing reasons for the increased in shareholder power, including the elimination of broker discretionary voting and the movement from plurality to majority and nonstaggered boards; "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 5–6, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

19. Marc Weingarten, "2012 Shareholder Activism Insight Report," The Harvard Law School Forum on Corporate Governance and Financial Regulation (blog), November 26, 2012, https://blogs.law.harvard.edu/corpgov/2012/11/26/2012-shareholder-activism-insight-report/.

20. "Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act," SEC, last modified February 14, 2013, http://www.sec.gov/spotlight/dodd-frank.shtml.

21. SEC, "SEC Adopts Rules for Say-on-Pay and Golden Parachute Compensation as Required Under Dodd-Frank Act," press release, January 25, 2011, http://www.sec.gov/news/press/2011/2011-25.htm.

22. "Proxy Advisory Business: Apotheosis or Apogee?," Corporate Governance Commentary, Latham & Watkins LLP (March 2011): 2–3, http://www.lw.com/upload/pubContent/_pdf/pub4042_1.pdf.

> independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that is in fact independent of an investment adviser may cleanse the vote of the adviser's conflict.[23]

In other words, if an independent proxy advisory firm recommends a proxy vote, then the mutual fund and its adviser can follow that recommendation and avoid a claim that it has a conflict of interest. A second important interpretation was that mutual funds and their advisers had to vote all their shares on all proxy issues on the basis of actively developed policies.[24] Overall, US issuers pose more than 250,000 proxy questions a year, and it is not unusual for large mutual funds and their advisers to be required to cast votes on more than 100,000 of them on the basis of actively developed voting policies.

By paying fees to proxy advisors, funds and their investment advisers could avoid being sanctioned by the SEC or being sued successfully by lawyers representing shareholders unhappy with particular proxy votes.[25] A 2011 study by the Center for Executive Compensation quotes Leo E. Strine Jr., vice chancellor of the Delaware Court of Chancery, saying, "Following ISS constitutes a form of insurance against regulatory criticism, and results in ISS have a large sway in the affairs of American corporations."[26] For the proxy advisors, the SEC's actions produced a bonanza of revenues—and of political power. Suddenly ISS became, as one recent report put it, "the de facto pay and governance police."[27]

The Egan-Jones letter helped ISS in another way. Part of ISS's business was advising listed firms ("issuers," in the parlance of regulators) on corporate governance, including recommendations on how to win proxy votes. While, on the face of it, this may seem to be a conflict, the SEC letter explicitly said that it was not.

23. "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.

24. The SEC's proxy policy rules have been interpreted to include a mandate to vote shares on the basis of actively developed policies. See Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010).

25. There are exceptions. In 2009, the SEC brought a complaint against INTECH Investment Management, LLC, alleging that the firm tried to curry favor with the AFL-CIO by adopting an ISS proxy-voting platform that followed the voting recommendations of the union. INTECH's aim, according to the SEC, was to improve its score on an annual AFL-CIO survey ranking investment advisers. A total of $350,000 in fines was assessed. See Order Instituting Administrative Cease-and-Desist Proceedings Pursuant to Sections 203(e), 203(f) and 203(k) of the Investment Advisers Act of 1940, Making Findings and Imposing Remedial Sanctions and a Cease-and-Desist Order, File No. 3-13463 (May 7, 2009), available at http://www.sec.gov/litigation/admin/2009/ia-2872.pdf.

26. Leo E. Strine, Jr., "The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face," *Delaware Journal of Corporate Law* 30 (2005): 688.

27. "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 15–16, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

> In your letter, you ask whether a proxy voting firm would be considered to be an independent third party if the firm receives compensation from an issuer ('Issuer') for providing advice on corporate governance issues. We believe that the mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser.[28]

III. THE DEPTH AND BREADTH OF ADVISORS' INFLUENCE

IN 2003, W. James McNerney Jr., then chairman of 3M Corporation, stated in a letter to the SEC that ISS controlled the proxy votes of half of his company's shares and that "many of the top 30 institutional shareholders we contacted in each of the past two years to discuss our position would not engage in any meaningful discussions, often citing adherence to ISS proxy voting guidelines."[29]

The McNerney letter was referenced in a study of proxy advisors published in the *Stanford Journal of Law, Business, and Finance*.[30] The study also cited Lynn Stout of Cornell, who wrote, "When institutional investors follow ISS [proxy recommendations] en masse, directors of public corporations can expect to see 20%, 30% even 50% of their company's shares being voted not as the directors recommend, but as ISS recommends."[31]

Of course, no single institution determines the outcome of every proxy vote, but, according to a study by David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, opposition by a proxy advisor results in a "20% increase in negative votes cast."[32] That figure underestimates the power of ISS and Glass Lewis since corporations trying to avoid a negative recommendation from a proxy advisory firm will shape their policies accordingly. Another study, published by researchers Jennifer E. Bethel and Stuart L. Gillan in the journal *Financial Management*, found that when ISS

28. "Investment Advisers Act of 1940—Rule 206(4)-6: Egan-Jones Proxy Services," SEC letter to Kent S. Hughes, May 27, 2004, http://www.sec.gov/divisions/investment/noaction/egan052704.htm.
29. "Comment from W. James McNery, Jr. on SEC Proposed Rule," SEC, December 5, 2003, http://www.sec.gov/rules/proposed/s71903/3m120503.htm.
30. Tamara C. Belinfanti, "The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight," *Stanford Journal of Law, Business, and Finance* 14 (Spring 2009): 386–87n14.
31. Ibid.
32. David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

recommends a "no" vote on a management proposal, affirmative votes decline by 13.6 percent to 20.6 percent.[33]

Between them, ISS and Glass Lewis clients control 25 percent to 50 percent of the typical mid-cap or large-cap company's shares, according to a study by a proxy solicitation firm.[34] Members of the Society of Corporate Secretaries and Governance Professionals "think that ISS alone controls one-third or more of their shareholders' votes."[35]

Last year a survey conducted by the Conference Board, NASDAQ, and the Stanford University Rock Center for Corporate Governance reported research demonstrating the influence that proxy advisory firms have over the design of corporate governance policies. Over 70 percent of directors and executive officers reported that their compensation programs were influenced by the policies or guidelines of proxy advisory firms.[36]

To a large degree, corporate directors and executives are now subject to decision making on critical issues by organizations that have no direct stake in corporate performance and make poor decisions as a result. Conscientious shareholders, who do have such a stake, also suffer because their votes are usurped or overwhelmed by these same organizations. The SEC's proxy policy rules have led to results unimagined by their original advocates.

Instead of mutual funds assuming more responsibility for their proxy votes, they have assumed less. Instead of providing more incentive for informed, sensitive voting on proxies, the incentive has been to outsource decision making to firms that, for understandable business reasons, make their recommendations using one-size-fits-all standards.

The problem is compounded because, as a result of the financial crisis, Congress and the president have decided to give shareholders more authority over directors—and that means more authority for proxy advisors, who play a key role in determining how shareholders vote. As Strine wrote, "The influence of ISS and its competitors over institutional investor behavior is so considerable that traditionalists will be

33. Stuart Gillan and Jennifer E. Bethel, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," University of Delaware Working Paper No. 2002-002, Newark, DE, 2002. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=354820.

34. Yin Wilczek, "Bounty Program to Cramp Corporate Boards: ABA Speakers Discuss Governance Provisions," Daily Report for Executives, *Bloomberg BNA*, Aug. 10, 2010, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 20, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

35. Quote from Susan E. Wolf, former chair of the Society, cited in "A Call for Change in the Proxy Advisory Industry Status Quo," Center on Executive Compensation (January 2011): 20, http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf.

36. The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions," (March 2012), http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."[37]

The victims of the unintended consequences are America's investors. As we shall see, research shows that rather than being enhanced, shareholder value is being depleted by the recommendations of proxy advisors because of inadequate professional standards, conflicts of interest, a lack of properly aligned incentives, ideological bias, or some combination of factors.

IV. SUSPECT ADVICE AND SHAREHOLDER VALUE

REGULATORS HAVE HANDED a valuable franchise, a franchise that lets them determine the shape of corporate governance in America, to two proxy advisory firms. If the decisions these firms make are good ones—that is, if they promote good governance and thus enhance shareholder value—the concentration of power might not be so troublesome. In that case, even in the absence of a regulatory mandate, institutions might want to make use of proxy firms. The key question is, How good is the firms' advice?

The objective of strong corporate governance is to enhance shareholder value, but it is by no means clear that ISS and Glass Lewis have achieved this objective with their recommendations. In fact, two serious studies found the contrary.

A July 2012 Stanford study titled "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies" looked at ISS and Glass Lewis recommendations on compensation policies and issued these stark conclusions:

> First, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period before the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms apparently in an effort to avoid a negative recommendation. Third, the stock market reaction to these compensation program changes is statistically negative. Thus, the proprietary models used by proxy advisory firms for say-on-pay recommendations appear to induce boards of directors to make choices that decrease shareholder value.[38]

37. Leo E. Strine Jr., "Toward a True Corporate Republic: A Traditional Response to Lucian's Solutions for Improving Corporate America," (John M. Olin Center for Law, Economics and Business Discussion Paper Series, Paper 541, Harvard Law School, Cambridge, MA, 2006), http://lsr.nellco.org/harvard_olin/541.

38. David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policy" (working paper, Rock Center for Corporate Governance at Stanford University Working Paper No. 119, Stanford, CA, 2012): Abstract, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453.

Specifically, the researchers found that, in their study of a total of more than 2000 firms, the "average risk-adjusted return" on the implementation of the recommendations "is a statistically significant –0.42%."[39]

In another Stanford study, in 2011, researchers looked at exchange offers—that is, transactions in which executives holding stock options are allowed to trade them in for new options. These offers (also called "re-pricing") typically occur when the original options the executives were granted are trading far out of the money and are unlikely to be worth much, if anything, in the future, thus destroying the incentive that options are supposed to produce.

Certainly, exchange offers can be abused, but whether to issue them is a subtle question that has no simple, uniform solution. Still, ISS has taken a strong stand on limiting exchanges. For example, it issues negative recommendations on exchanges in which executive officers or directors can participate or when new options vest in six months or less.

The study looked at 272 exchange offers and found that only 23 percent were compliant with ISS guidelines. This was a rare instance in which ISS's policies were not particularly influential, but it turned out better for shareholders that ISS was ignored. The researchers observed "a positive price reaction to [all] exchange offers, suggesting that shareholders view these proposals as value-increasing." In addition, "the stock price reaction is significantly less positive when the exchange offer is constrained to meet ISS guidelines." The authors also found that "future operating performance is lower and executive turnover is higher when the exchange program is constrained in the manner recommended by ISS."[40] Thus, the authors found that shareholders experienced better returns if they ignored ISS.

Shareholders do not always ignore ISS's policies in instances where they harm companies. An example is ISS's policies concerning the new Say-on-Pay voting mandate. SoP was immensely popular among state pension and union pension funds. Notably, no representatives from the mutual fund or hedge fund community were active in the debate over SoP, which one would expect if the practice created value for shareholders.[41] The focus that proxy advisors place on SoP votes may stem

39. Ibid, 4.

40. David Larcker, "Do ISS Voting Recommendations Create Shareholder Value?" (Rock Center for Corporate Governance at Stanford University, Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-13, Stanford, CA, April 19, 2011): 2, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1816543##.

41. At a Senate hearing at which one of the authors testified on this issue, the five-person panel included a representative from the American Federation of State, County and Municipal Employees, a powerful union, and one from the Council of Institutional Investors, a pension fund group controlled by state and union pension funds. Notably, no representatives from the hedge fund or mutual fund lobby were present or particularly supportive of pushing the rule forward at the SEC. The absence of hedge fund or mutual fund support indicates that SoP may be about political issues rather than a focus on shareholder returns. See *Hearing on Protecting Shareholders and Enhancing Public Confidence by Improving Corporate Governance Before the Senate Committee on Banking, Housing, & Urban Affairs*, 111th Cong. (July 29, 2009), http://www.banking.senate.gov/public/index.cfm?Fuseaction=Hearings.Hearing&Hearing_ID=c754605c-0b95-4139-a38a-63e63b4b3fa9.

more from conflicted interests in pleasing particular types of clients than in recommending value-enhancing voting policies.

ISS requires that the board obtain the votes of at least 70 percent of shareholders for its compensation plan, but the proxy advisor provides no evidence to support that arbitrary requirement. Nor does ISS show how SoP votes themselves encourage more efficient compensation policies. ISS also universally recommends annual say-on-pay votes—again, with no empirical support. What SoP votes do encourage (despite the fact that they are not technically binding) are lawsuits.[42]

ISS also backs other corporate governance policies for which the empirical evidence is mixed, at best, but which nevertheless enjoy support among politically motivated institutional investors. Current ISS policies indicate support for independent directors,[43] and the firm indicates it will support, on a case-by-case basis, proposals to give shareholders the right to nominate director candidates to the corporate proxy, despite evidence suggesting that proxy access generally fails to add value.[44] ISS guidelines also indicate opposition to options repricing, as we noted.[45] The evidence on all of these issues is mixed, at best.

ISS supports independent chairs,[46] but the literature is unclear on whether having a chairperson separate from the CEO correlates with increased returns.[47] Golden parachute agreements, which ISS opposes, are actually associated with increases in stock prices.[48] Similar critiques have been raised with respect to independent

42. Sarah A. Good, Cindy V. Schlaefer, and Ana N. Damonte, "Proxy Season Brings Third Wave of 'Gotcha' Shareholder Litigation," PillsburyLaw.com, February 21, 2013, http://www.pillsburylaw.com/publications/proxy-season-brings-a-third-wave-of-gotcha-shareholder-litigation.

43. This paragraph describes policies contained in ISS's most recent policy statement for the 2013 proxy season. See "2013 U.S. Proxy Voting Concise Guidelines," ISS (December 19, 2012), http://www.issgovernance.com/files/ISS2013USConciseGuidelines.pdf.

44. See Thomas Stratmann and J.W. Verret, "Does Shareholder Proxy Access Damage Share Value in Small Publicly Traded Companies?," *Stanford Law Review* 64 (2011): 1431–68.

45. The debate over whether options repricing is material to executive compensation packages is explored in Brian J. Hall and Thomas A. Knox, "Underwater Options and the Dynamics of Executive Pay-to-Performance Sensitivities," *Journal of Accounting Research* 42, no. 2 (May 2004): 365–412.

46. See generally Roberta Romano, *Foundations of Corporate Law*, 2nd ed. (New York: Thomson Reuters/Foundation Press, 2010) 410–25.

47. See, e.g., Paula L. Rechner and Dan R. Dalton, "CEO Duality and Organizational Performance: A Longitudinal Analysis," *Strategic Management Journal* 12, no. 2 (February 1991): 157. See also Audra L. Boone et al., "The Determinants of Corporate Board Size and Composition: An Empirical Analysis," AFA 2005 Philadelphia Meetings, Philadelphia, PA, March 2006. http://dx.doi.org/10.2139/ssrn.605762. See also "Comment from Fidelity Investments on SEC Proposed Rule," SEC, March 18, 2004, http://www.sec.gov/rules/proposed/s70304/fidelity031804.htm.

48. See generally Richard A. Lambert and David F. Larcker, "Golden Parachutes, Executive Decision Making and Shareholder Wealth," *Journal of Accounting and Economics* 7 (1985).

directors.[49] The jury is also still out on takeover protections that have been consistently opposed by ISS and Glass Lewis.[50]

More research is needed to establish with a strong degree of certainty whether proxy advisory recommendations consistently increase shareholder value. A problem with conducting such research is the lack of transparency on the part of the proxy advisors. A Conference Board survey related to advisory firm SoP recommendations concluded:

> While the evidence suggests that companies are aware of and react to proxy advisory policies as they relate to SOP, the evidence does not speak to whether these changes are positive or negative for shareholders. Until proxy advisory firm methodologies are vetted by third-party examiners, it cannot be determined whether these changes are beneficial to companies and their shareholders.[51]

Such third-party examinations will be difficult, if not impossible. As a Rock Center commentary stated:

> Ultimately, the accuracy of a recommendation can only be determined by rigorous statistical analysis showing positive impact of a governance choice on shareholder value. What rigorous empirical research supports each of the voting recommendations promulgated by proxy advisers? Why don't ISS and Glass Lewis disclose the specific research (either that they have conducted or conducted by third parties) that justifies each of their recommendations?[52]

49. Sanjai Bhagat and Bernard S. Black, "The Uncertain Relationship Between Board Composition and Firm Performance," *Business Law* 54, no. 3 (May 1999): 932.

50. Barry Baysinger and Henry Butler, "Antitakeover Amendments, Managerial Entrenchment, and the Contractual Theory of the Corporation," *Virginia Law Review* 71 (1985): 1302–3. See also Marcel Kahan and Edward Rock, "Corporate Constitutionalism: Antitakeover Charter Provisions as Precommitment," *Pennsylvania Law Review* 152 (2003): 516.

51. The Conference Board, NASDAQ, and Stanford Rock Center for Corporate Governance, "The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions" (March 2012): 6, http://www.gsb.stanford.edu/cldr/research/surveys/proxy.html.

52. David F. Larcker, Allan L. McCall, and Brian Tayan, "And Then a Miracle Happens! How Do Proxy Advisory Firms Develop Their Voting Recommendations?" (Rock Center for Corporate Governance at Stanford University Closer Look Series: Topics, Issues and Controversies in Corporate Governance and Leadership No. CGRP-31, Stanford, CA, 2013), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2224329.

V. TWO SOURCES OF LOW-QUALITY ADVICE

THE EVIDENCE STRONGLY suggests that proxy advisors do not enhance shareholder value with their recommendations. It is time to examine why. The problem begins with a simple fact: proxy advisors lack the resources to make adequate judgments. Currently, ISS has 1,300 clients and covers more than 40,000 meetings and every holding within client portfolios in more than 100 developed and emerging markets worldwide.[53] ISS does all this with a research staff of fewer than 200 persons.[54] The other major advisor, Glass Lewis, says that it "empower[s] institutional investors to make sound decisions by uncovering and assessing governance, business, legal, political and accounting risks at more than 23,000 companies in 100+ countries" with a total of just 300 employees, only 200 of whom are involved in research.[55] In addition, more than half of company shareholder meetings occur in a three-month span (April to June),[56] and this concentration makes thoughtful evaluations even more difficult.

A perverse outcome of the current system is that regulators are effectively separating the evaluation of corporate governance from investment analysis by driving funds to use crude alternatives to assess proxies, rather than the analytic expertise that they tout as their comparative advantage. A 2010 report published on the Harvard Law School forum found that

> at best, they may rely on statistical modeling in an effort to sort portfolio companies by performance, such as grading a company against a peer group determined by SIC codes or the like. . . . Voting decision makers do not and cannot utilize the tools of investment decision makers because it is simply not feasible to do so in the cost environment in which proxy advisors and internal corporate governance staffs are required to operate.[57]

53. "Proxy Advisory Services," ISS, accessed April 4, 2013, http://www.issgovernance.com/proxy/advisory.
54. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 6, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
55. "About Glass Lewis," GlassLewis.com, accessed April 4, 2013, http://www.glasslewis.com/about-glass-lewis/.
56. "A dialogue with Institutional Shareholder Services," Audit Committee Leadership Network in North America, ViewPoints, no. 139 (November 7, 2012): 6, https://webforms.ey.com/Publication/vwLUAssets/Proxy_advisory_firms/$FILE/ViewPoints_39_November_2012_Dialogue_with_ISS.pdf.
57. Charles Nathan, "The Parallel Universes of Institutional Investing and Institutional Voting," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, April 6, 2010, http://blogs.law.harvard.edu/corpgov/2010/04/06/the-parallel-universes-of-institutional-investing-and-institutional-voting/.

On February 19 of this year, the Norges Bank Investment Fund (NBIF), the world's largest sovereign wealth fund ($650 billion), released a report questioning the application of one-size-fits-all universal codes for evaluating corporate governance.[58] The NBIF report concluded that "principles should be seen as best practices and that considered deviation must be expected and welcomed." The implication is that the models used by proxy advisors are no substitute for informed analysis that considers the mission and background of each individual fund and looks carefully not just at rules and guidelines but also at the real-life nature of each proxy question.

An especially egregious example of the current reliance on guidelines and models involves Warren Buffett, perhaps the most respected investor and corporate leader of the past 40 years, a man brimming with experience and integrity. His company, Berkshire Hathaway, first bought Coca-Cola shares in 1988 and had amassed $10 billion worth of stock, making Coke at the time its largest single investment. Buffett had long served on the audit committee of the board.

But in April 2004, ISS opposed Buffett's reelection because some of Berkshire's companies, like Dairy Queen, sell Coke products, thus creating what ISS saw as a conflict. According to an ISS press release, "The recommendation is based on ISS's best practice corporate governance guidelines that call for completely independent audit committees."[59]

Buffett was reelected to the board anyway, and he commented, "I think it's absolutely silly. . . . Checklists are no substitute for thinking."[60] We do not suggest that it is necessarily wrong to focus on conflicts of interest on audit committees or otherwise; however, we do suggest that ISS's failure to consider Buffett's history with the company, his stature, and the firm's own compliance with rigid New York Stock Exchange listing rules for audit committee membership indicate a recommendation process that is unsophisticated and "one size fits all."

Checklists are precisely what the regulators have encouraged. For example, ISS guidelines state that the firm will recommend voting against directors of a company that does not act on a shareholder proposal that received a majority of votes in the previous year.[61] This sort of checklist item, of course, means that SoP "precatory," or advisory, votes actually carry the authority of being nearly mandatory. More importantly, the checklist item fails to take into account the possibility that directors may

58. Norges Bank Investment Management, NBIM Discussion Note: Corporate governance, November 19, 2012, http://www.nbim.no/Global/Documents/Dicussion%20Paper/2012/DiscussionNote_14.pdf.

59. ISS, "Institutional Shareholder Services' Response to Coca-Cola Director: Herbert Allen's April 15 Wall Street Journal Op-Ed Misses Point on Audit Panel Independence at Coke," PR Newswire, April 15, 2004, http://www.prnewswire.com/news-releases/institutional-shareholder-services-response-to-coca-cola-director-72496527.html.

60. David Larcker and Brian Tayan, *Corporate Governance Matters: A Closer Look at Organizational Choices and Their Consequences* (New Jersey: FT Press, 2011), 403.

61. See ISS guidelines referenced in note 43 on page 15.

have more information or wisdom than shareholders, or that events have occurred in the intervening year that supersede the original vote. It is telling that ISS is willing to make that generalized recommendation in the absence of clear evidence whether the underlying successful shareholder proposal will add value at the company.

In addition, ISS toughened some of its standards in 2013, giving shareholder votes even more weight. According to an article in a trade publication, "The firm will now consider a proposal to have gained majority support if it wins a majority of shares cast, not just a majority of shares outstanding. That's a significant change, since many shareholders never cast their votes."[62]

The problem with checklists is that they simplify the complexities of business reality. Consider the matter of ISS's reliance on determining appropriate compensation by linking it to what a company's peer group members are paying. Company A may be on the ropes because a CEO just died or the company is simply performing poorly. The pool of top CEOs in the industry may be tiny, and competitors may be grabbing market share. Company A's directors may believe that hiring away Company B's CEO will both hurt a competitor and help Company A in a time of dire need, and to get B's CEO to move may require doubling his or her salary and offering substantial stock options. Such nuances occur in real life but not on the checklists of ISS and Glass Lewis.

Besides a lack of resources, proxy advisory firms lack the right incentives to make decisions that meet the interests of shareholders. As a working paper from the University of Pennsylvania School of Law states,

> Proxy advisors do not have a financial stake in the companies about which they provide voting advice; they owe no fiduciary duties to the shareholders of these companies; and they are not subject to any meaningful regulation. Moreover, it is not clear that the proxy advisory industry is sufficiently competitive and transparent to subject advisory firms—ISS in particular—to substantial market discipline.[63]

By contrast, the same paper points out that directors have powerful incentives to make the right decisions. They own shares in their companies, they are subject to lawsuits, and they risk their personal reputations. The danger is that "boards may do what they believe ISS wants them to in order to keep their seats, whether or not their belief is justified."[64]

62. Joseph McCafferty, "Proxy Advisers Make Changes to Voting Guidelines for 2013," *Compliance Week*, December 7, 2012, http://www.complianceweek.com/proxy-advisers-make-changes-to-voting-guidelines-for-2013/article/271784/.
63. See Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59 (2010): 872.
64. Ibid.

VI. THE ADDITIONAL PROBLEM OF CONFLICTS OF INTEREST

WHEN THE SEC adopted its rule requiring mutual funds to disclose their proxy voting policies, Chairman Harvey Pitt emphasized that the principal motivation for the new rule was his concern about potential couflicts of interest that mutual fund advisors face in voting their shares. He noted: "Because the securities are held for the benefit of the investors, they deserve to know the fund's proxy voting policies and whether they were in fact followed. Many wield voting power in the face of conflicts; they may cast votes furthering their own interests rather than those for whom they vote."[65]

Conflicts of interest deserve considerable discussion. Let's begin by looking at the results of poor advice under similar circumstances at credit-rating agencies.[66]

Federal regulators have designated nine firms as "nationally recognized statistical rating organizations."[67] One of the key functions of these NRSROs is to determine the creditworthiness of corporate and government borrowers and of specific bond issues. Two private firms dominate the market, though not quite as thoroughly as ISS and Glass Lewis dominate proxy advice. The two are Standard & Poor's, which according to the most recent SEC survey accounted for 44,500 of the 99,286 ratings of corporate issuers in 2010, and Moody's, which accounted for 30,285. Between them, the two firms accounted for 75 percent of the market for corporate bonds; a third firm, Fitch, added another 14 percent. S&P and Moody's had an even larger share—83 percent—of the market for rating government securities, with Fitch accounting for nearly all the rest.[68]

An array of financial regulations requires banks, insurance companies, and other institutions "to use credit ratings to establish investment risk standards for their portfolio holdings,"[69] for example, to meet capital requirements. After the financial crisis of 2008–09, credit-rating agencies, with conflicts of interest similar to proxy advisory firms, came under criticism for underestimating the risk involved in asset-backed securities, which they also rate (S&P and Moody's controlled 73 percent of that market in 2010; Fitch, another 21 percent). On February 5 of this year, the

65. "Speech by SEC Chairman: Remarks at the Commission Open Meeting," Chairman Harvey L. Pitt, SEC, January 23, 2003, http://www.sec.gov/news/speech/spch012303hlp.htm.
66. Editorial, "Standard & Poor's Stands Accused," *New York Times*, February 5, 2013, http://www.nytimes.com/2013/02/06/opinion/standard-poors-stands-accused.html.
67. "Annual Report on Nationally Recognized Statistical Rating Organizations," SEC (March 2012): 6–7, https://www.sec.gov/divisions/marketreg/ratingagency/nrsroannrep0312.pdf.
68. Ibid., 9–10
69. Ibid., 15.

Department of Justice brought suit against S&P, charging that severe harm was inflicted on investors.[70]

The problem was not simply that credit-rating firms misjudged risk (either innocently or because of conflicts of interest) but that—just as with proxy advisory firms—regulators conferred substantial evaluative powers on a few firms, thus enabling institutions that engaged those firms to pass off responsibility for exercising their own fiduciary duty to conduct an informed analysis of the suitability of securities held in client accounts.

Proxy advisors don't literally or legally have the same license as credit-rating agencies, but their oligopoly is eerily similar. The fear now is that the regulations that have empowered a few proxy advisers are leading to the same adverse results as the rules that have empowered a few rating agencies.[71]

Remember that the main purpose of the 2003 SEC rule on proxies was to address problems caused by conflicts of interest between institutions and the shareholders whose assets they manage. In fact, the conflicts have merely been shifted to different firms. The conflicts have actually been exacerbated by the rule, since their regulatory mandate gives proxy advisors substantial market power. Before the 2003 rule, competitive pressures were already encouraging some mutual funds to disclose information about their proxy voting policies to customers.[72] Now those competitive pressures are less effective.

There are two major kinds of conflicts of interest that afflict proxy advisors. The first is that advisors may beinfluenced by some of their largest clients to make recommendations that serve those clients' social and political interests. As James R. Copland of the Manhattan Institute wrote in a *Wall Street Journal* op-ed: "ISS receives a substantial amount of income from labor-union pension funds and 'socially responsible' investing funds, which gives the company an incentive to favor proposals that are backed by these clients."[73] As a result, the behaviors of proxy advisors "deviate from concern over share value, [suggesting] that this process may be oriented toward influencing corporate behavior in a manner that generates private

70. "Department of Justice Sues Standard & Poor's for Fraud in Rating Mortgage-Backed Securities in the Years Leading Up to the Financial Crisis," United States Department of Justice (February 5, 2013), http://www.justice.gov/opa/pr/2013/February/13-ag-156.html. To be clear, the authors doubt that this particular lawsuit has merit. See "Payback for a Downgrade? The Feds Sue S&P but not Moody's for Pre-crisis Credit Ratings," *Wall Street Journal*, February 5, 2013, http://online.wsj.com/article/SB10001424053111903596904576518460162935404.html.

71. Charles M. Nathan and Parul Mehta, *The Parallel Universes of Institutional Investing and Institutional Voting* (Rochester, NY: Social Science Research Network, 2010), 3.

72. See "Comment from Franklin Templeton Fund on SEC Proposed Rule," SEC, December 9, 2002, http://www.sec.gov/rules/proposed/s73602/mlsimpson1.htm.

73. Opinion, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, October 7, 2012, http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

returns to a subset of investors while harming the average diversified investor."[74] The legacy of the SEC's proxy policy rules appears to have encouraged a focus, in the words of SEC Commissioner Daniel Gallagher, on "social and political issues rather than issues that would be material to investors."[75]

The second variety of conflict that taints advisors is that they provide consulting services to the issuers about whom they make voting recommendations to mutual funds. These consulting services are designed precisely to facilitate managers' obtaining favorable recommendations. Copland writes about ISS:

> About 20% of its revenues also come from consulting contracts with companies about corporate governance issues and executive compensation, according to MSCI's 2011 annual report. Shareholder proposals that increase corporate sensitivity to ISS preferences would have the effect of increasing the incentive for public companies to enter into such consulting contracts with ISS. . . . From 2006 to 2012, ISS supported 35% of shareholder proposals related to environmental issues such as global warming or natural-gas hydraulic fracturing, and 70% of proposals seeking to increase disclosure of or to limit corporate political spending. Only one such proposal has received the support of a majority of shareholders.[76]

The SEC's Egan-Jones Letter, issued by the SEC shortly after its proxy advisor rule was enacted, addressed this potential conflict:

> An investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon the proxy voting firm's recommendations with respect to an Issuer because the proxy voting firm could recommend that the adviser vote the proxies in the firm's own interests, to further its relationship with the Issuer and its business of providing corporate governance advice,

74. James R. Copland, Yevgeniy Feyman, and Margaret O'Keefe, "Proxy Monitor 2012: A Report on Corporate Governance and Shareholder Activism" (Fall 2012): 3, http://proxymonitor.org/pdf/pmr_04.pdf.

75. Ning Chiu, "SEC Commissioners take divergent views on corporate governance and related disclosure regulations," *Lexology*, February 26, 2013, http://www.lexology.com/library/detail.aspx?g=d121d7fb-a090-4338-aff7-55d8b5fe13c1.

76. Opinion, "Politicized Proxy Advisers vs. Individual Investors," *Wall Street Journal*, October 7, 2012, http://online.wsj.com/article/SB10000872396390444620104578012252125632908.html.

> rather than in the interests of the adviser's clients. The proxy voting firm's relationship with an Issuer thus may present a conflict of interest that is in addition to any conflict of interest that the investment adviser may have.[77]

While the SEC staff clearly recognized the potential for conflict, the letter then took a turn that was surprisingly deferential to the proxy advisory firms by suggesting that disclosure would be sufficient to relieve the problem:

> Accordingly, an investment adviser should obtain information from any prospective independent third party to enable the adviser to determine that the third party is in fact independent, and can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. . . . For instance, under the circumstances that you describe in your letter, the procedures should require a proxy voting firm that is called upon to make a recommendation to an investment adviser regarding the voting of an Issuer's proxies to disclose to the adviser any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from an Issuer.[78]

This approach stands in stark contrast to other situations in which the SEC has issued regulations motivated by conflict-of-interest concerns in the arena of corporate governance. In cases involving investment analysts, for instance, the SEC has been quite aggressive. In its regulation of some non-audit advisory services offered by firms that conduct financial audits, the SEC was similarly dismissive of arguments that conflicts of interest could be managed merely through disclosure.[79] (Debates over the advisability of the SEC's approach to potential conflicts of interest involving investment advisers or auditors are beyond the scope of this paper. The examples suggest that the SEC's soft approach to proxy advisory firm conflicts of interest has been uncharacteristic.)

The Department of Labor, which regulates pension plans nnder ERISA (Employee Retirement Income Security Act of 1974, the main law regulating pension plans), has taken a more forceful stand against conflicts of interest in voting proxies. DOL's Advisory Opinion 2007-07A expressed "strong concern about the

77. SEC to Hughes, May 27, 2004.
78. Ibid.
79. See, e.g., Strengthening the Commission's Requirements Regarding Author Independence, 68 Fed. Reg. 6006 (February 5, 2003) (to be codified at 17 C.F.R. pts. 210, 240, 249, and 274).

use of plan assets to promote particular legislative, regulatory or public policy positions that have no connection to the payment of benefits or plan administrative expenses."[80] The letter used this example:

> The likelihood that the adoption of a proxy resolution or proposal requiring corporate directors and officers to disclose their personal political contributions would enhance the value of a plan's investment in the corporation appears sufficiently remote that the expenditure of plan assets to further such a resolution or proposal clearly raises compliance issues under [ERISA].[81]

In March 2011, the DOL's inspector general issued a report warning that unions may be using "plan assets to support or pursue proxy proposals for personal, social, legislative, regulatory, or public policy agendas."[82] The inspector general noted that the Employee Benefits Security Administration (ESBA), the division of DOL that enforces ERISA, often lacked adequate assurances that plan fiduciaries or third parties like proxy advisory firms base their votes or recommendations for votes on actual economic benefit.[83] It appears that the Labor Department's Inspector General shares our concern that corporate voting policies by some politically active funds may be conflicted.

It is possible that conflicts of interest posed by proxy advisory firms accepting consulting fees from issuers may already be prohibited under ERISA—or expose plan fiduciaries or proxy advisors to liability under the law. DOL has contemplated designating proxy advisors as fiduciaries under ERISA, a question beyond the scope of our analysis.[84] Even in the absence of such a rule, reliance on proxy advisors who provide consulting services may be prohibited.

When an ERISA fiduciary (that is, an official or firm with influence over pension plan investments) appoints others to fulfill its obligations—such as when it gives voting power to a proxy advisor—the ERISA fiduciary also has an obligation to monitor those appointees.[85] If relying on an expert that also receives fees from those whom the expert is assessing—fees that relate to the very matters in question—is deemed unreasonable, then ERISA fiduciaries may not meet their obligations for prudence.

Also, under ERISA, when a fiduciary acts to the benefit of a third party, even if

80. See 29 C.F.R. § 2509.94-2 (2008).
81. Ibid.
82. "Proxy-voting May Not be Solely for the Economic Benefit of Retirement Plans," Department of Labor, Office of Inspector General—Office of Audit, Employee Benefits Security Administration, Report No. 09-11-001-12-121 (March 31, 2011): 4–8, http://www.oig.dol.gov/public/reports/oa/2011/09-11-001-12-121.pdf.
83. Ibid.
84. Definition of the Term "Fiduciary," SEC, 75 Fed. Reg. 65,263, (October 22, 2010).
85. See Shirk v. Fifth Third Bancorp, No. 05-cv-49, 2007 WL 1100429, at *16 (S.D. Ohio April 10, 2007).

the fiduciary's own interest is not implicated, the fiduciary may violate its duty.[86] In addition, the lack of company-specific recommendations by proxy advisors and the limited empirical evidence supporting those recommendations call into question whether ERISA fiduciaries are fulfilling their obligations.

While the SEC's fiduciary rules for investment advisers are less developed than the Department of Labor's, many of the same principles could also inform interpretive guidance from the SEC to regulate the role of conflicts of interest faced by proxy advisors in corporate governance.

Some proxy advisors or ERISA fiduciaries might provide boilerplate disclosure about the possibility of conflicts stemming from consulting fees, yet in analogous contexts, like those involving auditors whose firms offer consulting services, institutional investor groups have been highly suspicious and have found disclosure or firewalls to be insufficient remedies.

For instance, the California Public Employees' Retirement System (CalPERS) advocates the following clear principle on auditor independence: "The external auditor should not provide internal audit services to the company."[87] Consulting services provided by the same entity that provides the external assessment represent an unavoidable conflict of interest in the view of CalPERS, which, with $254 billion in assets, serves 1.6 million members. It would seem that a similar problem is present when the same proxy advisory firm may be called upon to provide an external rating of a corporate governance proposal or mechanism it helped design.

In addition, the Council of Institutional Investors advocates that "a company's external auditor should not perform any non-audit services for the company, except those, such as attest services, that are required by statute or regulation to be performed by the company's external auditor."[88] Some proxy advisors have attempted to keep their work in proxy recommendations separate from their consulting work for issuers.[89] Still, it would seem inconsistent to argue that auditors providing tax structuring advice or internal audit consulting to the issuers they audit represent such an obtrusive conflict of interest that the practice must be banned outright, and at the same time argue that proxy advisors can successfully avoid the conflicts posed by providing consulting services to the issuers about whom they make voting recommendations.[90]

Indeed, the analogy to auditing fees actually *understates* the conflict involved. To be fully analogous, we would have to consider a situation where auditors provided issuers with consulting services about how to navigate successfully an outside audit (and by the same firm).

86. See Bevel v. Higgonbotham, Civ.-98-474-X, 2001 WL 1352896, at *14 (E.D. Okla. Oct. 4, 2001).
87. See Global Principles of Accountable Corporate Governance, CalPERS, November 14, 2011 at 27.
88. See Global Principles of Accountable Corporate Governance, CalPERS, November 14, 2011.
89. See Concept Release on the U.S. Proxy System, SEC, 75 Fed. Reg. 42,981, 43,009 (July 22, 2010).
90. See "Comment from Council of Institutional Investors on SEC Proposed Rule," SEC, January 10, 2003, http://www.sec.gov/rules/proposed/s74902/sabteslik1.htm.

Courts have held that obligations imposed by ERISA should be construed consistently with those of the federal securities laws.[91] Thus, to the extent that these principles cross over to the fiduciary obligations owed by proxy advisors and the investment advisers who rely on them, similar restrictions and liability risks from proxy advisor consulting fees may be present.

We have now examined three sources of low-quality advice: lack of resources, misaligned incentives, and conflicts of interest. Conflicts may already violate DOL regulations, which in turn provide guidelines for the SEC to follow. We have other recommendations as well to fix the current broken system.

VII. RECOMMENDATIONS

THE PROXY ADVISORY industry was principally created by regulation. Without regulatory mandates requiring active participation in proxy votes, and without interpretative releases giving preferential treatment to investment managers who use proxy advisors, a profitable proxy advisory industry might not exist.

There are legitimate concerns about merely adding more regulations, such as requirements that proxy advisors further "professionalize" their staffs or that a mandatory disclosure regime be created to solve a problem caused by regulation. The result of additional rules, as with credit-rating agencies, is often to make the regulated institutions less open to competition and closer to their regulators, a phenomenon known as "regulatory capture." Also, as we have seen, regulations often produce unintended consequences. It was no surprise that the US Chamber of Commerce, in a set of proposals in March for repairing the proxy advisory system, rejected the regulatory approach.[92]

On the other hand, replacing poor regulations with well-designed regulations can render businesses more exposed to the normal market forces that produce good outcomes.

The Egan-Jones letter shifted fiduciary responsibility for proxy decisions from mutual funds to third parties while simultaneously limiting the fiduciary exposure of those third parties. In the end, except in extraordinary cases, no one is responsible for representing the interests of shareholders. As a remedy, the law firm Wachtell, Lipton, Rosen & Katz argued, according to a piece in the *New York Times*, "that proxy advisory services should be subject to the proxy solicitation rules. If these rules applied, shareholders and public companies could sue the advisory services over disclosure lapses in their recommendation reports."[93] It is possible, of course,

91. *Shirk*, 2007 WL 1100429, at *15.

92. Ross Kerber, "Chamber of Commerce wants more proxy advisor disclosures," Reuters, March 20, 2013, http://www.reuters.com/article/2013/03/20/us-proxy-advisors-chamber-idUSBRE-92J0SL20130320.

93. Steven M. Davidoff, "Proxy Firms Need More Rules, Companies Say," DealBook, November 30, 2010, http://dealbook.nytimes.com/2010/11/30/in-one-area-companies-want-more-regulation/.

that "by imposing this liability, the ability of proxy advisors to make recommendations would be chilled, if not killed."[94] This paper does not suggest either a mandatory disclosure regime or the Lipton proposal, though both are valid options that deserve a place in the debate.

At a bare minimum, regulators must act to end to proxy advisor services' conflicts of interest, actual and potential. The firms must choose their clients: either corporate share issuers or investment institutions such as mutual funds—but not both. Even if this conflict were eliminated, the change would not remove that possibility that ISS would favor the ideological and political views of large proxy-advisory clients. That bias can't be removed through oversight, only through competition. In other words, if it were more broadly known that ISS recommendations diminished shareholder value, both kinds of potential clients might look elsewhere for advisory services.

Knowledge about shareholder value depends on research, and this sort of research is difficult to design because the advisory firms lack transparency. If regulators eliminate rules that offer preferential treatment to proxy advisors and the firms that use them, and eliminate the regulatory mandate for active voting policies, disclosure will occur voluntarily through market forces. This voluntary disclosure can occur along the lines recently suggested by the US Chamber, asking that proxy advisors

> review the effects of their recommendations six months, or as practicable, after relevant proxy votes, and publish those results (with other necessary data) to permit interested persons to assess the accuracy, validity, and appropriateness of the PA Firm's recommendations. . . . These reviews should permit regularly revisiting and, if appropriate, modifying, proxy voting policies to ensure that they have a positive—or at a minimum no negative—effect on shareholder value.[95]

Unfortunately, ISS issued a response to the Chamber's suggestion that illustrates the extensive buffer it enjoys from market competition:

> We take exception with the Chamber's misinformed characterization of the proxy advisory industry and with their disrespect for the financial institutions that are our clients and, ironically, some of the Chamber's own members. . . . We are accountable to our

94. Ibid.

95. "Best Practices and Core Principles for the Development, Dispensation, and Receipt of Proxy Advice," Center for Capital Markets Competitiveness, Chamber of Commerce (March 2013): 7, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/Best-Practices-and-Core-Principles-for-Proxy-Advisors.pdf.

> clients who place their confidence in our service, to the companies we analyze and to the regulators that set the real guidelines for fiduciary responsibility. The Chamber should take its own advice by grounding its "Principles" in actual facts rather than its own self-serving interests.[96]

Fixing the current system also requires that we acknowledge that mutual funds can't possibly make considered judgments about tens of thousands of proxies, and that it is not in their best interest to do so. "Institutional investors like mutual funds and pension funds do not have the resources to analyze and consider all these proposals," as Steven Davidoff, a law school professor, wrote in the *New York Times*.[97] TIAA-CREF, for instance, holds stock in 7,000 companies and must cast more than 100,000 votes a year. Instead of requiring mutual funds to engage in active analysis of tens of thousands of votes, the SEC could allow funds and their advisers to determine when such analysis would be in their fund's best interest. This approach recognizes that the ultimate source of the problem is not the way ISS conducts its business but the burden the SEC has imposed on mutual funds that made them turn to ISS in the first place.

That burden is compounded by Dodd-Frank's insistence that shareholders cast certain votes, such as Say-on-Pay. We believe such proxy requirements are unnecessary. If issuers ignore the wishes of shareholders, then shareholders will take appropriate action through self-funded proxy fights, filing civil lawsuits, taking short positions, or simply voting with their feet by selling shares, thereby sending the powerful signal of a falling stock price.

In the absence of such a policy shift, many institutional investors cannot or will not dedicate sufficient resources to develop individual assessments of all proxies. And, since the SEC has provided them with what appears to be a legal "safe haven," these mutual funds will continue to turn to firms like ISS, firms that cannot adequately evaluate all the companies in the investment universe.

On the other hand, if the SEC recognized the limitations of the current policy, investors would benefit from lower costs and a decrease in the risk associated with centralized decision making. This change would not necessarily eliminate the role of proxy advisors but would reduce it to its proper weight in the scheme of corporate governance. Holly Gregory of the law firm Weill, Gotshal & Manges recently wrote on the blog of the Harvard Law School Forum on Corporate Governance

96. "ISS Response to the U.S. Chamber of Commerce's Guidelines for Proxy Advisory Firms," ISS, accessed April 4, 2013, http://www.issgovernance.com/press/issreponsechamberofcommerce.
97. Davidoff, "Proxy Firms Need More Rules, Companies Say."

and Financial Regulation, "Decisions to utilize the services that proxy advisors offer should be made on an informed basis after appropriate due diligence, especially if the shareholder is an institutional investor that owes fiduciary duties to beneficiaries."[98]

Those fiduciary duties include serious considerations of costs versus benefits. A perverse result of mandating that institutions vote all matters on a company proxy is that the SEC is essentially saying all issues are important to all shareholders. In fact, the potential benefits realized by voting on certain items, as required by SEC regulations, are outweighed by the cost to the fund of conducting a proper evaluation—a cost ultimately absorbed by the shareholders. In other words, the cost of, say, deciding how to vote proxies on 1,000 shares of a stock owned by a mutual fund with high turnover *subtracts* from shareholder value.

A report by the law firm Latham & Watkins, LLP, cites a 2008 interpretation by the Department of Labor, which found

> that an investment adviser's fiduciary duty requires it first affirmatively to conclude that the potential economic benefits to share value arising from the act of voting outweighs [*sic*] the costs of voting (including the risk that the vote could decrease share value), with voting being appropriate only for those matters at a particular company that are determined to have greater benefit than cost.[99]

So far, neither the Department of Labor nor the SEC has reconciled this need for benefit-cost analysis with universal active proxy voting policy requirements. While the 2008 DOL interpretation tried to address the universal active voting mandate, a shift in priorities and a lack of enforcement at the DOL has since undercut the 2008 interpretive letter.

The SEC also has yet to address the responses to its 2010 concept release on proxy voting. When it does, it must recognize that its own interpretation of the original 2003 rule is at the root of the trouble—and the trouble is that two small firms, and one in particular, have become the central arbiters of corporate governance in America, and those firms are not equipped or incentivized to make value-enhancing decisions.

98. Holly Gregory, "Preserving Balance in Corporate Governance," *The Harvard Law School Forum on Corporate Governance and Financial Regulation* (blog), February 1, 2013, http://blogs.law.harvard.edu/corpgov/2013/02/01/preserving-balance-in-corporate-governance/.

99. "Proxy Advisory Business: Apotheosis or Apogee?," *Corporate Governance Commentary*, Latham & Watkins LLP (March 2011): 2, citing 29 C.F.R. § 2509 (2008).

Three steps are needed to fix the problem:

1. Limit proxy voting requirements of mutual funds and pension funds so that those institutions will be the sole arbiters of when it makes sense to vote using active analysis of the question at hand. The test should be whether the vote enhances the value of an investment to a significant degree and whether the benefits of the voting process exceed the costs.
2. End the preferential regulatory treatment that proxy advisors currently enjoy in the law. That process must start by rescinding the Egan-Jones letter issued by the SEC staff. Institutional investors would remain free to purchase proxy advisory services if those services are valued for their own merit. Continued resistance by proxy advisors to sharing the empirical foundation for their recommendations suggests demand for their services may decline in the absence of their regulatory advantages.
3. End extraneous proxy requirements, such as Say-on-Pay votes. Let shareholders and directors decide the matters that should be put to votes, if any, beyond those already required under state corporate law.

All three steps are reasonable, nonideological, and address a pressing problem. They should be relatively easy to accomplish. However, if step 2 is not enacted, we would advocate as an alternative limiting proxy advisors to a single business in order to mitigate conflicts of interest. They can advise issuers on corporate governance and getting proxy proposals passed, or they can advise mutual funds and other financial institutions on how to vote—but not both. As we noted in the previous section, such a conflict may already subject ERISA plans relying on proxy advisors to potential liability. The SEC's rules for mutual funds and their advisers recognize this conflict.

The time for reform is now. The regulatory advantages proxy advisory firms enjoy should be curtailed in the interest of America's shareholders.

Outsourcing Shareholder Voting to Proxy Advisory Firms

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Draft: May 10, 2013

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*Corresponding author 655 Knight Way, Stanford, CA 94305-7298. We thank Yonca Ertimur, Fabrizio Ferri, Joseph Grundfest, Katherine Rabin and seminar participants of the 2012 London Business School Accounting Symposium for helpful comments. Ormazabal acknowledges funding from the Ramon y Cajal and Marie Curie Fellowships. Michelle Gutman and Brian Tayan provided excellent research help for this project. We would also like to thank Institutional Shareholder Services for providing some of the data used in this project and the Stanford Rock Center for Corporate Governance and the Stanford Graduate School of Business Center for Leadership Development and Research for their support.

Outsourcing Shareholder Voting to Proxy Advisory Firms

Abstract: This paper examines the economic consequences of institutional investors outsourcing research and voting decisions on matters submitted to a vote of public company shareholders to proxy advisory firms. These outsourcing decisions appear to be the result of the regulatory requirement that institutional investors vote their shares combined with incentives for these investors to minimize their cost of voting activity. We investigate the implications of these decisions in the context of shareholder say-on-pay voting required in 2011 under the Dodd-Frank Act. Analyzing a large sample of firms from the *Russell 3000* that are subject to the initial say-on-pay vote mandated by the Dodd-Frank Act, we find three primary results. First, consistent with prior research, proxy advisory firm recommendations have a substantive impact on say-on-pay voting outcomes. Second, a significant number of firms change their compensation programs in the time period *before* the formal shareholder vote in a manner consistent with the features known to be favored by proxy advisory firms in an effort to avoid a negative voting recommendation. Third, the stock market reaction to these compensation program changes is statistically *negative*. These results suggest that the outsourcing of voting to proxy advisory firms appears to have the unintended economic consequence that boards of directors are induced to make choices that *decrease* shareholder value. While this evidence does not speak to the optimality of outsourcing all voting decisions compared to alternative regulatory constructs (e.g. prohibiting proxy advisors or reducing the number of items to be voted on), it does inform this debate by providing evidence on the potential negative economic consequences of outsourcing shareholder voting to proxy advisors.

Keywords: proxy advisory firms; say-on-pay; institutional shareholder voting

JEL Classification: G1; G3; K2; L5

1. Introduction

Significant regulatory, financial press and academic research attention has been paid in recent years to mechanisms that will give shareholders of public companies more control over firms' corporate governance. While most of the focus has been on actual or perceived failings of corporate governance within firms, relatively little attention has been paid to how large institutional shareholders actually utilize their increased influence to affect the governance choices of individual firms.[1] This is an especially important issue because the number of opportunities for shareholders to cast votes on various corporate governance items has increased in recent years (e.g. through shareholder proposals and mandated votes such as say-on-pay) and firms are increasingly responsive to voting results.[2]

Like many instances of voting by a dispersed base, shareholder voting is subject to free rider problems because any individual shareholder's vote likely matters very little, but they bear the full cost of researching matters subject to vote. While retail investors can choose to not vote, institutional investors have a fiduciary obligation to cast votes on virtually all shareholder ballots, and therefore they represent the preponderance of votes cast. If the free rider problems sufficiently dilute the benefits of engaging in costly research to identify the optimal voting choice, institutional investors may choose to engage in a low cost voting strategy that meets their regulatory requirements but might not result in optimal feedback to the firms. In this paper, we examine the characteristics and the economic consequences of institutional investor voting, and in particular the outsourcing of voting to cost-effective third parties such as proxy advisory firms.[3]

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[1] Our focus is on governance choices influenced through the regular corporate vote channels. This is different from research on shareholder activism (e.g. Gillan and Starks, 2007, and Barber, 2007) which has been largely inconclusive on the value implications to shareholders.

[2] Among firms covered by ISS Voting Analytics the average number of ballot items per firm increased from 6.48 in 2003 to 9.46 in 2011.

[3] A recent (somewhat extreme) example of outsourcing is the decision of BlackRock to outsource voting on the question of whether to split the chairman and CEO for JPMorgan Chase to Governance for Owners. Since

Institutional investors generally have a fiduciary responsibility to vote shares in their portfolios in a manner that is beneficial to their shareholders.[4] In 2003, the SEC further increased the requirements for mutual funds by requiring them to disclose their voting policies as well as disclose how they actually voted on every ballot item. A key objective of this regulation was to motivate institutional investors to monitor firms in a manner that benefits all shareholders (SEC, 2003). However, institutional investors tend to have relatively small holdings in a large number of stocks making the cost of researching every ballot item at each annual meeting for all stocks in their portfolio costly.[5] Moreover, the economic benefits to an institutional investor conducting this research (presumably by forcing appropriate governance changes and reducing agency problems) are likely to be quite small because an individual fund only recognizes the partial benefit associated with its small ownership stake in firms where the investor is the pivotal voter, while incurring all the costs of this research activity (i.e., traditional free-rider problems confront each institutional investor). One consequence of this is that shareholder voting processes have taken on characteristics of compliance function (i.e., making sure that the votes are cast according to a specific policy), as opposed to an activity involving the portfolio managers who are engaged in research resulting in buy or sell decisions for shareholders in the funds.[6]

BlackRock owned approximately 6.5% of the shares of JPMorgan Chase, they were required to outsource to an independent third party under the Bank Holding Company Act (see Craig and Silver-Greenberg, 2013).

[4] Throughout the paper, we use the term "institutional investors" to include all non-individual investors such as mutual funds, pension funds, endowments, insurance companies, and other similar entities. These investors usually have a fiduciary responsibility to vote their shares, but the relevant controlling regulations vary across investor types. Mutual funds are a subset of the larger group that are specifically subject to the changes in voting requirements and disclosure of actual votes implemented in by the SEC in 2003

[5] Glass Lewis & Co. notes, "Most institutions do not have adequate in-house resources to ensure that the right decisions are being made on the hundreds or thousands of proxies they vote each year". Source: www.glasslewis.com/solutions/proxypaper.php (accessed April 22, 2011)

[6] For instance, at Fidelity Investments, according to their proxy voting policy, proxy voting is conducted by a separate internal group and does not explicitly provide for input or recommendations from portfolio managers or research analysts covering the firm on many common proxy items. Fidelity's policy provides for consulting portfolio managers on items for which no guidelines have been established. However guidelines have been established for many common circumstances, including director elections, equity compensation plans, stock option exchanges and "say-on-pay" advisory votes, implying that portfolio managers would not ordinarily participate in the

In this market setting, we would expect "corporate governance research entities" such as proxy advisory firms to form and invest in costly data collection and research where this cost is ultimately shared across many institutional investor clients.[7] That is, institutional investors will tend to outsource their voting decisions to these proxy advisory firms as long as their net benefits will exceed those from doing all the necessary research in-house.[8] This is even a more likely outcome after the SEC (2003) issued an interpretation that the use of proxy voting policies developed by an independent third party (i.e., proxy advisors) would be deemed free of a conflict of interest and would meet mutual funds' proxy voting obligations. Thus, the least costly way to satisfy an investors' regulatory responsibility to cast shareholder votes can easily be to outsource voting to Institutional Shareholder Services (ISS) or Glass Lewis (GL).

The important public policy issue in this setting is whether the payments made by institutional investors are sufficient for the proxy advisory firms to engage in costly research to develop "correct" governance recommendations from the perspective of firm shareholders. If the institutional investors are only using the proxy advisor voting recommendations to meet their compliance requirement with the lowest cost, these payments will not compensate proxy advisors for conducting research that is necessary to determine appropriate corporate governance structures for individual firms. Under this scenario, the resulting recommendations will tend to be based on simple, low cost approaches that ignore the complex contextual aspects that are almost certainly instrumental in selecting the corporate governance structure for individual firms. Given the

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review of those items (Fidelity Funds' Proxy Voting Guidelines, November 2010). Other firms completely outsource the voting process to third-party proxy advisors, bypassing input from portfolio managers.

[7] Since institutional investors hold shares in many thousands of individual domestic and international companies, a proxy advisory firm must have sufficient scale to provide voting recommendations for many proposals for this large number of firms. Thus, there are substantial fixed costs to start a competitor firm and the prospects of success are likely to be low given the "first mover" advantages of the two largest firms (ISS and Glass Lewis). Over the past decade, new entrants have failed to generate any meaningful market share (e.g., Egan Jones). The proxy advisory industry has the classic oligopoly structure.

[8] An additional alternative available to institutional investors would be to make no investment in research of proxy items and simply make an arbitrary voting decision, such as always following management's recommendation. This strategy would carry significant legal/regulatory risk because, if discovered, the institution may have violated its fiduciary duty to its shareholders.

theoretical and practical difficulty of selecting corporate governance, there is no reason to assume that a simple approach to voting recommendations is optimal for the affected firms. However, if proxy advisors can influence enough shareholder votes, boards of directors will be forced or induced to respond by changing executive compensation programs and governance structure in a manner consistent with the recommendations of proxy advisor firms. The obvious question that remains to be answered is whether or not the confluence of government regulations, the outsourcing of recommendations the proxy advisory industry, and responses by boards of directors to these recommendations, produces an increase in shareholder value as anticipated by government regulators (SEC, 2003).

In this paper, we examine impact of institutional shareholder voting, particularly the outsourcing of research and recommendations to proxy advisory firms, in the setting of shareholder say-on-pay voting. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) imposed a requirement that public companies allow shareholders the opportunity to cast an advisory vote on executive compensation (typically annually) beginning in 2011. This requirement is commonly referred to as say-on-pay (SOP).[9] Shareholders that disagree with a firm's executive compensation program can cast a non-binding (or precatory) vote "against" the management compensation program disclosed in the proxy statement for the annual shareholder meeting. The primary regulatory assumption with SOP is that firms will make changes to their compensation program when a substantial proportion of negative (against) votes are cast by shareholders.

The implementation of SOP voting provides several advantages to other shareholder vote issues for purposes of evaluating the economic impact of vote outsourcing to proxy advisors.

[9] Prior to the Dodd-Frank Act, firms receiving aid under the Troubled Asset Relief Program (TARP) were required to conduct SOP votes beginning in 2009, and a small number of non-TARP firms voluntarily adopted SOP votes prior to Dodd-Frank.

First, the regulation is broad, effecting most of the U.S. equity market. Second, because this is a new proxy ballot item, inferences are less confounded by questions of timing (e.g., whether actions might be in response to a past vote or in anticipation of a future vote). Finally, we exploit the fact that while SOP voting was new for most public companies, the policies used by proxy advisors to develop their recommendations were well publicized and known to boards of directors in advance the first SOP votes required by Dodd-Frank Act. This enables us to examine changes that boards of directors make to compensation programs *in anticipation of* the initial SOP votes and the shareholder reaction to those changes. If a board anticipates opposition to its executive compensation program and believes that this opposition is costly to shareholders (e.g., because it invites derivative lawsuits, negative press, regulatory scrutiny, or distracts executives and employees) or is personally costly to them (e.g., through litigation or reputation risk), it might rationally take preemptive actions to decrease the probability of receiving negative votes. In such a setting, the board of directors will be interested in anticipating whether institutional investors (who generally hold the majority of outstanding shares) will vote for or against a SOP proposal.

We document that many institutional investors rely on proxy advisory firms, primarily ISS and GL, for data and analysis to guide their voting choices. Although each institutional investor ultimately controls the votes cast for its own shares, it is common for funds to rely in whole or in part on the policies and guidelines of proxy advisory firms to inform their SOP voting decisions (Belinfanti, 2010). For example, SEI Investment Management, Grantham, Mayo, and Van Otterloo, Evergreen Investment Management, Dimensional Fund Advisors, Wells Fargo Funds Management, and Nuveen Asset Management voted more than 99% of the time with the ISS recommendation. Similarly Charles Schwab, Neuberger Berman, Loomis

Sayles, and Invesco disclose that they follow GL SOP recommendations.[10] As a result, depending on their shareholder base, it is possible for firms to substantially decrease votes against SOP by obtaining a positive recommendation from proxy advisory firms.

This shift in expected voting outcomes can be accomplished by making changes to the compensation program so that its features more closely align with the voting policies of the proxy advisory firms before the proxy statement is released and these firms issue their SOP voting recommendation. For example, in a recent survey conducted by The Conference Board, NASDAQ, and the Stanford Rock Center for Corporate Governance (2012), over 70% of the director and executive officer respondents indicated that their compensation programs were influenced by the policies of and/or guidance received from proxy advisory firms during their evaluation of SOP. If the policies and guidelines of proxy advisors effectively identify poor pay practices, changes made by boards of directors to align their executive compensation programs more closely with these policies will decrease executive rent extraction and increase shareholder value. However, if proxy advisor voting policies do not identify suboptimal corporate governance, changes made to align executive compensation programs with these policies could move compensation contracts away from the optimal structure and reduce the value of the firm. We provide insight into these potential shareholder value implications by examining the determinants of the SOP voting outcomes (including proxy advisor recommendations), assessing whether boards of directors make compensation plan changes that are favored by proxy advisors in anticipation of the first SOP vote, and estimating the economic consequences of these decisions for shareholders.

[10] While GL does not publish their recommendations to non-subscribers, we confirm that these institutions make the same vote in more than 99% of cases, which is consistent with use of the same recommendations.

Our tests are based on 2,008 firms from the *Russell 3000* index that held their shareholder meeting in 2011 and were required to have a SOP vote under the Dodd-Frank Act. Consistent with prior research (e.g., Bethel and Gillan, 2002, Cai, Garner, and Walking, 2009, and others), we first show that the proxy advisory firm recommendations substantially influence the voting tally. For example, a simple univariate analysis reveals that firms that received a negative recommendation by ISS (GL) obtained an average 68.68% (76.18%) voting support in SOP proposals.[11] In contrast, firms that did not receive a negative recommendation from ISS (GL) obtained an average of 93.4% (93.7%) support in those proposals. This differential voting effect is even more pronounced when the specific institutions owning shares in the firm historically rely more heavily on ISS recommendations (i.e., institutions are more likely to vote in line with ISS recommendations when there is a disagreement between the voting recommendation of ISS and management). Specifically, for negative SOP recommendations, we find that firms with investors that have an above-median likelihood of voting with ISS exhibit 63.5% support for the proposal, whereas firms where that likelihood is below median exhibit 73.5% support for the proposal.

As a result of their ability to influence SOP votes, proxy advisory firms can induce firms to adopt compensation plan features that they are known to favor (e.g., performance-based equity and elimination of tax gross-ups in change of control plans).[12] While firms rarely discuss the specific role of proxy advisors in making changes to executive compensation in their public

[11] In the first year of SOP, firms in our sample received, on average, 90.27% approval from shareholders. However, 13.24% of companies received at least 20% votes against their plan and 32 of the sample companies actually failed their vote (less than 50% of vote cast in favor of management's proposal).

[12] For example, General Electric stated that changes were made to stock options previously granted to the CEO after "a number of constructive conversations with shareowners" (General Electric SEC Form DEFA14A filed April 18, 2011). Disney initially tried to argue that shareholders should ignore a negative vote recommendation from ISS (The Walt Disney Company SEC Form DEFA14A filed March 2, 2011), but later removed the key feature causing the negative ISS recommendation without discussion of the reason (The Walt Disney Company SEC Form DEFA14A filed March 18, 2011). ISS changed their SOP recommendation for Disney on the same date (ISS Proxy Voting Report dated March 18, 2011).

filings, reports by business media indicate that these changes were made in response to proxy advisor policies.[13]

Our primary tests examine compensation changes made in the time period *preceding* the SOP vote that better align the compensation program with known proxy advisor policies. We find that these changes are more likely to be observed among firms that expect to receive a negative SOP recommendation in the absence of a compensation plan change and where ISS can influence a substantial number of shareholder votes. Since most executive compensation changes must be publicly disclosed on Securities and Exchange Commission (SEC) Form 8-K, it is possible to precisely estimate the stock market assessment of these decisions by the board of directors. We find that the average risk-adjusted return on the 8-K filing date is a statistically significant -0.44% lower among compensation changes aligned with proxy advisor policies than among compensation changes unrelated to proxy advisor policies. Moreover, this effect is unique to 8-K changes in the time period before SOP and similar results are not observed for earlier time periods.

As with all observational studies, there are a variety of alternative interpretations of this result. However, we believe that the most plausible conclusion is that the confluence of the regulatory environment and free ridership problems inherent in shareholder voting leads institutional investors to outsource the proxy voting decision to proxy advisory firms, but that they are not willing to pay for research sufficient to induce optimal governance choices in firms.

[13] For example, see Joann S. Lublin, "Firms Feel 'Say on Pay' Effect," *The Wall Street Journal*, May 2, 2011; and Andrew Dowell, and Joann S. Lublin, "Strings Attached to Options Grant for GE's Immelt," *The Wall Street Journal*, April 20, 2011. Twelve firms made changes to (or commitments to change) compensation programs after filing their proxy statement containing the SOP proposal, and subsequently received a positive recommendation from ISS. Ten of these firms received a positive ISS recommendation on the same date as the public announcement of their revised compensation programs, one received positive recommendation two days later, and the last firm received a positive recommendation three weeks later. Nine of the 12 firms had received an initial negative recommendation from ISS that was reversed to a positive recommendation when the firm disclosed its changes. The other three firms received their initial (positive) recommendation from ISS immediately after filing amendments to their proxy statements.

As a result, the proprietary SOP policies of proxy advisory firms induce the boards of directors to make compensation decisions that *decrease* shareholder value. While we cannot assess the overall social welfare effect related to the outsourcing of proxy voting to the proxy advisory industry, this paper informs this debate by providing evidence on the potential negative economic consequences of outsourcing shareholder voting to proxy advisors.

The remainder of the paper consists of six Sections. Section 2 discusses the institutional background for proxy advisory firms, SOP and prior research on these topics. Section 3 describes our sample selection. Section 4 presents our analysis of the determinants of proxy advisors' SOP recommendations. Section 5 assesses the influence of proxy advisors on shareholder voting. Section 6 examines the responses by boards of directors to proxy advisors' policies, the economic consequences of these responses, and an assessment of alternative interpretations of our results. Summary and concluding remarks are provided in Section 7.

2. Institutional Background and Literature Review

2.1 Proxy Voting Requirements for Institutional Investors

Institutional investors are generally fiduciaries for the ultimate economic owners of the assets they are investing, which obligates them to a duty of care and loyalty that includes exercising the voting rights on shares in their portfolios. Prior to 2003, there was little insight into how individual institutional investors were actually using their voting power. In response to concerns that institutional investors were conflicted in their voting by other business dealings with issuers, as well as significant pressure from organized labor groups, the SEC adopted new voting requirements in 2003 (Cremers and Romano, 2009). The key requirements of the 2003 regulations were for mutual funds to disclose their votes on all shareholder ballot items, as well

as the policies and procedures used to determine their vote (SEC, 2003). The SEC summarized the objectives of requirements in the final rule:

> Proxy voting decisions by funds can play an important role in maximizing the value of the funds' investments, thereby having an enormous impact on the financial livelihood of millions of Americans. Further, shedding light on mutual fund proxy voting could illuminate potential conflicts of interest and discourage voting that is inconsistent with fund shareholders' best interests. *Finally, requiring greater transparency of proxy voting by funds may encourage funds to become more engaged in corporate governance of issuers held in their portfolios, which may benefit all investors and not just fund shareholders* (SEC, 2003, emphasis added).

The objectives stated by the SEC clearly assume that institutional investors will conduct the research necessary to cast votes that will lead to "optimal" corporate governance choices. However, each institutional investor also faces a classic free rider problem. Most institutional investor holdings are relatively small portions of each firm's total securities [in our sample, the mean (median) holding is 0.3% (0.03%)]. This makes it unlikely that a given institution is a pivotal voter on any ballot item. Most of these institutions also hold a large number of securities, making the cost of engaging in research necessary to determine the correct vote on every proxy item very high. These free rider problems make it clear that there are economic incentives for institutional investors to not invest in costly research on proxy votes.

Determining how to vote on complex issues of corporate governance typically involves evaluating a wide range of idiosyncratic firm issues, such as each director's experience and their cumulative skills, appropriateness of firm oversight and strategy, firm compensation relative to firm strategy, personal characteristics of executives, practices of other industry and labor market competitors, and many others features of the economic setting. This type of research is not the primary business of most institutional investors. As a result, outsourcing this research (and in many cases the voting decision) may be the most cost efficient means of meeting their obligation

to vote their owned shares.[14] At the same time the new proxy voting rules were finalized, an interpretative letter from the SEC provided that the use of proxy voting policies and recommendations developed by an independent third party such as proxy advisors would be deemed free of a conflict of interest and would meet mutual fund proxy voting obligations. From a compliance perspective, this ruling provided considerable incentives for mutual funds to rely on the recommendations of third-party proxy advisory firms, particularly when they might be perceived to have conflicts of interest arising from other business dealings (Belinfanti, 2010). If the free rider problems are substantial and portfolio managers do not use the proxy advisory firm recommendations in stock selection, institutional investors will not pay higher fees for better research beyond that necessary to meet the simple compliance requirements. If the resulting ISS and GL SOP recommendations are inappropriate, corporate governance changes induced by these votes are unlikely to increase shareholder value. These concerns have not gone unnoticed by the SEC, as (former) Commission Chairwoman Mary Shapiro noted, the SEC will:

> "...be examining the role of proxy advisory firms. Both companies and investors have raised concerns that proxy advisory firms may be subject to undisclosed conflicts of interest. *In addition, they may fail to conduct adequate research, or may base recommendations on erroneous or incomplete facts*" (emphasis added).[15]

2.2 Proxy Advisory Firms

Past research has documented that proxy advisor recommendations have a significant impact on the voting outcomes on various types of shareholder ballot items. For example, Morgan, Poulsen, and Wolf (2006) investigate trends in shareholder voting on management

[14] For instance, passive index funds typically do not conduct firm-specific corporate governance research for their trading activities. Although actively managed funds may trade on selected governance characteristics, this does not appear to be a key part of their typical fundamental investment strategies based on our interviews with portfolio managers at six large mutual funds. Moreover, the recent Tapestry Networks and IRRC Institute (2012) study of how mutual funds vote finds that many funds outsourced their voting on say-on pay to proxy advisory firms.
[15] Speech by Mary Schapiro, from *NACD Directorship Magazine*, Dec. 2010/Jan. 2011, p. 48

sponsored compensation programs. Over the time period from 1992 to 2003, affirmative voting for these management sponsored proposals declined, and in particular, negative vote recommendations of a proxy advisory firm resulted in a 20% increase in negative votes cast. Similarly, Bethel and Gillan (2002) and Cai, Garner, and Walking (2009) find that a negative ISS recommendation on a management proposal can sway between 13.6% to 20.6% and 19% of votes, respectively. Prior research clearly establishes a strong association between negative recommendations by proxy advisory firms and subsequent voting outcomes for management proposals. However the precise nature of the role of proxy advisors remains unclear.

Thomas, Palmiter and Cotter (2012) point out that proxy advisors may represent an aggregation of institutional investor perspectives that allow the industry to effect corporate governance changes in a coordinated way. From this perspective, proxy advisory firms may simply be an informative conduit between institutional investors and firms. However, Larcker, McCall and Tayan (2013) evaluate the public disclosures of the processes by which proxy advisors develop their voting guidelines and show that there is considerable discretion applied in translating the diverse feedback (using questionnaires and informal discussions) from investors and corporate issuers into specific voting recommendations. That is, the voting recommendations are not a simple tabulation of views expressed by institutional investors. Regardless of whether proxy advisors provide independent assessments and/or simply aggregate the views of institutional investors, it is important for researchers, shareholders, and regulators to understand whether ultimate policies that are adopted are value enhancing for firm shareholders.

The economic implications of outsourcing voting decisions to proxy advisors are unclear in prior literature. Larcker, McCall and Ormazabal (2012) examine the consequences of designing stock option repricing programs according to proxy advisor policies and find that

programs that are constrained to meet proxy advisor criteria are less valuable to shareholders. Alexander, Chen, Seppi, and Spatt (2010) provide insight into the role of proxy advisors in the context of contested director elections. They conclude that an ISS recommendation in favor of the dissident slate can serve as both an indicator for the likelihood that the dissident slate is elected and as a certification of the value of the dissidents to shareholders. However, the setting of contested elections is quite different from typical proxy ballot items. In particular, the decision to propose opposing director slates is a relatively rare occurrence that comes from dissident shareholders rather than management, and proxy advisors have different processes and (more seasoned) research teams for evaluating contested elections and merger and acquisition transactions (Winter, 2010).

2.3 Regulation of Executive Compensation and Shareholder Say-On-Pay

Concerns and criticisms over the reasonableness of compensation levels for managers of publicly traded companies has been a topic of interest for journalists, politicians, and researchers for at least a century. Efforts to restrict executive compensation have typically utilized either taxes (e.g., Internal Revenue Code Regulations 162m and 280G)[16] to make certain arrangements prohibitively expensive or increased disclosure (e.g., the 1992 and 2006 revisions for reporting executive compensation in the annual proxy statement or SEC Filing DEF 14A) in an effort to motivate boards and executives to make changes in response to pressure from shareholders or the public.[17] Research examining the effects of IRC 162m has shown modest effect on the form but not the level or performance sensitivity of executive compensation (e.g., Hall and Liebman,

[16] IRC 162m limits the deductibility of executive compensation to $1 million per year for each named executive officer unless the compensation qualifies as "performance-based" under the code. 280G imposes a 20% excise tax on "golden parachute" payments following the acquisition of the company if they exceed certain thresholds. The 1992 and 2006 revisions to proxy reporting regulations represented substantial revisions of the disclosure regime, significantly increasing the tabular and narrative disclosure of compensation to named executive officers (e.g., see Freher, 1992, and Buck Consultants, 2006 for discussion of changes).

[17] Core, Guay, and Larcker (2008) also find little evidence that negative discussion in the press causes firms to reduce the level or change the mix in executive compensation.

2000, Rose and Wolfram, 2002). In fact, some research suggests that pay levels actually rose in the wake of increased disclosure requirements (Murphy 1998).

"Say-on-pay" provides shareholders with a new mechanism to influence executive pay. Instead of legislating particular practices, shareholders are given the opportunity to evaluate a firm's publicly disclosed compensation practices and provide direct feedback to boards of directors through a non-binding shareholder vote. With the passage of the Dodd-Frank Act, nearly all U.S. public companies are required to provide shareholders with a non-binding advisory vote on executive compensation beginning with annual shareholder meetings occurring on or after January 21, 2011.[18] Shareholders are asked whether they approve of the executive compensation programs as disclosed in the Compensation Discussion and Analysis (CDA) of the annual proxy statement. Prior to the Dodd-Frank Act, U.S. firms that received federal assistance under the Troubled Asset Relief Program (TARP) were required to provide SOP proposals to shareholders. However, for other firms, providing shareholder SOP voting was voluntary.[19]

Cai and Walkling (2011) examined the market reaction to the passage of a say-on-pay bill in the House of Representatives and found that firms with excess compensation saw a positive market adjusted return, suggesting that shareholders believe this monitoring mechanism would be effective. However, Cai, and Walkling (2011) also find that firms that are targeted by labor unions with shareholder proposals on executive compensation experienced a negative reaction to

[18] In its final rule on SOP, the SEC provided a temporary exemption to the SOP requirement for companies with a public float less than $75 million. These firms will be required to implement SOP votes in annual meetings on or after January 21, 2013 (see: http://www.sec.gov/news/press/2011/2011-25.htm).

[19] SOP related activity has been increasing in recent years, beginning with shareholder pressure on firms to implement SOP votes through the shareholder proposal process, voluntary adoptions and requirements for TARP participants. In 2007 (2008) there were approximately 50 (90) shareholder proposals calling for SOP votes which garnered average support of 40.8% (41.7%) in favor. In 2008, Aflac, Inc. and RiskMetrics Group, Inc. (then the parent company of ISS) submitted SOP votes to shareholders. In 2009, TARP participants were required by the American Recovery and Reinvestment Act to provide a SOP vote, and other companies, notably Verizon Communications Inc. and Motorola, Inc. voluntarily introduced SOP votes after shareholder proposals received majority support (Hodgson 2009).

the proposal disclosures. This result may indicate a potential cost if certain shareholders and activists are able to use the mechanism to possibly pursue an agenda different from making decisions to increase shareholder value. In contrast, Larcker, Ormazabal, and Taylor (2011) find that stock market reactions to the SOP provision in Dodd-Frank Act are decreasing in CEO pay levels. This suggests that observed compensation choices are the result of value-maximizing contracts between shareholders and management, and broad government actions that regulate such governance and compensation choices are value destroying.

While the Dodd-Frank Act represents the first time that U.S. companies have been required to provide a SOP vote, a similar non-binding vote structure has been in place since 2002 in the United Kingdom.[20] Carter and Zamora (2009) and Alissa (2009) find that negative votes are associated with measures of excess compensation, and that boards respond to negative votes by reducing excess salary levels and by forcing out highly paid CEOs. Ferri and Maber (2013) find that firms adjust contractual features and increase the sensitivity of pay to performance in response to negative voting outcomes. However Conyon and Sadler (2010) did not find any change in the overall level of executive pay or its rate of growth subsequent to SOP votes.[21] Thus, whether SOP produces compensation contracts that are more desirable from the perspective of shareholders remains an important and unresolved question.

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[20] In 2003, Netherlands required companies to submit compensation policy changes to a binding vote. In 2005, Sweden and Australia both adopted requirements for non-binding shareholder votes on remuneration reports. It is noteworthy that each of these countries has significant requirements for pay disclosure. Norway, Spain, Portugal, Denmark and, most recently, France, have followed suit. In Canada, as of the end of April 2009, 12 of the country's largest companies have agreed to give their shareholders a non-binding vote on executive compensation. In 2013, voters in Switzerland passed a referendum requiring a *binding* SOP vote and German legislators have promised legislation giving investors more control of executive pay.

[21] U.S. shareholders have also historically had the ability to influence corporate governance outcomes, including executive compensation, outside of SOP votes. For example, Del Guercio, Seery, and Woidtke (2008) examine boards' response to shareholders withholding votes for director candidates and find evidence that they are associated with subsequent governance improvements. Ertimur, Ferri, and Muslu (2011) also examine director voting and non-binding shareholder proposals and find that targeted firms with high excess CEO pay see greater shareholder support for the proposals and subsequently reduce CEO pay.

2.4 Institutional Shareholder Services Say-on-Pay Voting Policies

In order to understand the ISS process for determining SOP voting recommendations, we reviewed the ISS 2011 U.S. Proxy Guidelines (ISS, 2011a) and a sample of other research reports purchased directly from ISS. ISS notes three primary considerations that can result in a negative SOP recommendation: misalignment between CEO pay and performance, problematic pay practices, and poor communication and responsiveness to shareholders. In addition, ISS evaluates five components of executive pay and assigns each either a high, medium or low level of concern. The five categories are (1) Pay for Performance Evaluation, (2) Non-Performance-Based Pay Elements, (3) Peer Group Benchmarking, (4) Severance/CIC Arrangements, and (5) Compensation Committee Communication and Effectiveness (ISS, 2011b).

The ISS "Pay for Performance Evaluation" conducts an initial screen based on recent total shareholder return (TSR). The screen first considers whether the one-year and three-year TSR are below the median of all the firms in the same four-digit Global Industry Classification Standard (GICS) code. If both the one and three year TSRs are below the corresponding medians of the GICS group, ISS examines whether the total compensation of a CEO who has served for at least two full fiscal years is aligned with total shareholder return over time (ISS, 2011a). The primary measure for evaluating alignment of CEO compensation highlighted in ISS reports is the one-year change in total compensation.[22] ISS also considers other elements of CEO pay alignment, including a graphical presentation of total CEO compensation and TSR over the previous five years and the percentage of equity compensation that is "performance-based"

[22] In defining "total compensation", ISS closely follows the presentation of the summary compensation table, and includes a combination of realized pay (e.g., salary, bonus payments, cash long-term incentives) and the expected value of awards that will be earned in the future (e.g., stock options, restricted stock).

(i.e., where the vesting of awards is contingent on meeting performance targets).[23] In the "Non-Performance-Based Pay Elements" analysis, ISS evaluates the reasonableness of elements they consider not performance based, including the value of perquisites, existence and cost of tax gross-ups on perquisites and non-qualified pension plans, and accumulated present value of pension obligations to the CEO. In their policy document (ISS, 2011a) ISS also notes that they consider repricing underwater stock options without shareholder approval a problematic pay practice that could result in a negative recommendation.

In their "Peer Group Benchmarking" analysis, ISS considers whether the firm's choice of peer companies and the target pay positioning against those peer companies are appropriate. The "Severance/CIC Arrangements" analysis identifies problematic features in severance and change-in-control (CIC) contracts for executives. In its policy document (ISS, 2011a) ISS identifies three features of new or extended CIC arrangements that they view as problematic: (1) payments exceeding three times the sum of salary and bonus; (2) payments made in the absence of involuntary job loss (i.e., single-trigger contracts); and (3) the provision of gross-up payments to offset golden-parachute excise taxes. The "Compensation Committee Communication and Effectiveness" analysis evaluates the disclosure of executive compensation in the proxy statement (which includes the role of the CEO in setting pay, disclosure of performance targets and compensation benchmarking practices) and the Board's responsiveness to investor input on compensation issues (which includes responses to majority-supported shareholder proposals and significant opposition to SOP votes) (ISS, 2011a).

2.5 Glass, Lewis & Co. Say-on-Pay Voting Policies

[23] It is interesting to point out that ISS and GL do *not* consider stock options or restricted stock with time-based vesting (which is the most common vesting criteria) to be performance-based pay elements.

Glass Lewis provides significantly less information on their policies in public documents.[24] Based on the available information, GL appears to use metrics that are similar to ISS in their SOP recommendation. However their approaches for determining an ultimate vote recommendation generate different results in many cases.[25] Specifically, GL organizes their analysis of executive compensation into three sections, "Pay-for-Performance", "Structure", and "Disclosure". Their proprietary "Pay-for-Performance" model results in a letter grade (A, B, C, D, or F) for each firm. The analyses of compensation "Structure" and "Disclosure" result in ratings of "Poor", "Fair" or "Good" (GL, 2012)

To determine their "Pay-for-Performance" rating, GL compares a firm's compensation to a peer group of firms developed using a proprietary computation. They then compare the percentile ranking of the firm against the peer group companies in two compensation metrics (CEO total compensation and total compensation of the top five executives) and seven performance metrics (stock price change, change in book value per share, change in operating cash flow, EPS growth, total shareholder return, return on equity and return on assets) over the prior one-, two- and three-year periods. Their model generates a weighted average compensation percentile and a weighted average performance percentile, and the difference between those values is referred to as the "pay-for-performance gap". The firm is then given a grade based on a forced grading curve (e.g., with the 10% of firms with the highest gap receiving an "F" and the

[24] Unlike ISS, GL does not generally provide researchers with a means of accessing their proxy reports. We requested access to GL proxy reports for this study, but GL responded that they had provided their reports to other academics on an exclusive basis. GL's proxy recommendation policy document (GL 2011a) also does not provide a detailed description of their process for determining recommendations. Therefore, we rely on GL reports obtained from web-based searches and the discussion of GL policies in Ertimur, Ferri, and Oesch (2013) which is based on the actual GL proxy reports.

[25] Ertimur, Ferri, and Oesch (2013) report that ISS and GL make the same recommendation 77.0% of the time. However, conditional on at least one of the firms making a negative recommendation, they agree only 17.9% of the time. This is consistent with our findings. We find that the unconditional agreement is 78.6% and conditional on at least one negative recommendation it is 22.5%. This is in part due to GL issuing almost twice as many negative recommendations as ISS, but even within the subset of firms receiving a negative recommendation from ISS, we (Ertimur, Ferri, and Oesch, 2013) find that the rate of agreement is only 48.1% (44.4%), indicating that although the model inputs are similar, the algorithms do have distinct features.

10% with the lowest gap receiving an "A" (GL, 2011b)). GL does not provide details of its analysis of the "Structure" category in its public policy documents. Ertimur, Ferri, and Oesch (2013) report that more than fifty different features of compensation programs are cited, and that the five most common items are (respectively) a lack of clawback provisions, limited performance-based nature of incentive plans, various types of tax gross-ups, controversial features in CIC plans, and lack of ownership requirements.

Similar to the "Structure" analysis, GL does not provide details of how it determines its "Disclosure" rating in its public policy documents. However, the two primary concerns driving Poor ratings for "Disclosure" appear to be lack of disclosure of performance metrics or goals and lack of disclosure of how equity awards are determined.[26]

3. Sample

Our initial sample consists of all firms included in the *Russell 3000* index during 2010. Since the composition of this index varies slightly across calendar quarters, our initial sample is composed of firms that appear in at least one quarter (n = 3,062). We focus on companies that held their shareholder meeting in 2011, have data available in Compustat, CRSP, Equilar (the source of our compensation data), and Voting Analytics. We also exclude firms that held their shareholder meeting before January 21, 2011 and smaller reporting entities (public float of less than $75 million) because those firms were not required to conduct a SOP vote in this period. We focus on companies that filed their proxy statement in the first half of 2011 because actions preceding later shareholder meetings might be confounded by the actions taken by competitors in

[26] Similar to the findings in the ISS evaluation, Ertimu, Ferri, and Oesch (2013) find that a poor score in the pay-for-performance model ("D" or "F") was associated with the most negative recommendations (89.2%). Other features that they document leading to negative recommendations include lack of performance-based equity plans, various types of tax gross-ups, controversial features in change of control plans, discretionary elements of pay, and lack of clawback provisions.

response to SOP and because during those months ISS announced changes in its voting policies for the 2012 proxy season. Finally, we require the firms to have an available ISS SOP recommendation and a CEO with tenure of at least two years in order to allow for a comparison of changes in CEO pay and firm performance. Our selection process produces a final sample of 2,008 firms.

Table 1 presents descriptive statistics of the sample firms and the 4,513 firms in the CRSP-Compustat universe with fiscal-year end dates from 6/30/2010 to 3/31/2011. The 2,008 sample firms capture approximately 71% of the market capitalization of this benchmark group. The mean (median) market capitalization of the sample firms is 5,982 (1,173) million dollars compared to the mean (median) market capitalization of the firms in the CRSP-Compustat universe of 3,750 (499) million dollars. We find that our sample firms also have a lower book-to-market ratio, lower return volatility, and higher percentage of shares owned by institutions than the benchmark group. In terms of industrial sectors as defined by Fama and French groups, we find that the industry affiliation of the sample firms is similar to that of the benchmark group (Table 1, Panel B).

4. Determinants of Proxy Advisory Firm Say-on-Pay Recommendations

4.1 Proxy advisory firm Say-on-Pay recommendations

We collect the ISS SOP voting recommendations from the ISS Voting Analytics database. We construct *ISS_against* as equal to one if the ISS recommendation was against SOP and zero otherwise. ISS recommended against 13% of the firms in our sample (Table 2, Panel A). Glass Lewis' recommendations are not publicly available. However, it is straightforward to infer GL recommendations from the voting behavior of four funds that publicly disclose that their SOP vote follows GL policies: Charles Schwab, Neuberger Berman, Loomis Sayles, and

Invesco (confirmed by each fund's proxy voting policies included in their 2011 Statement of Additional Information). We collect the SOP voting decisions of these four funds from SEC Form NPX disclosures and find that they vote in the same way in the vast majority of cases.[27] We construct *GL_against* as equal to one if those funds vote against the SOP proposal and zero otherwise. We find that GL recommended against 21% of our sample (Table 2, Panel A), which is considerably more aggressive than ISS, and consistent with the level of opposition reported by GL (Glass Lewis, 2012). [28] As might be expected, ISS and GL recommendations are highly correlated. ISS and GL recommendations coincide in approximately 79% of the cases, but they differ in 395 cases out of 1849 observations for which we have both ISS and GL recommendations (Table 2, Panel B). It is also interesting to note that no firm that received a positive ISS recommendation failed to pass the SOP proposal, whereas for GL one firm that received a positive GL recommendation did not obtain a majority support from shareholders.

4.2 Proxy advisory firm SOP policies

As discussed in Section 2, ISS and GL provide public information about their SOP voting policies. This information enables firms to make an "informed guess" about the likelihood of receiving a negative voting recommendation before their proxy statement is drafted, and possibly before the fiscal year end. However, an interesting question is whether proxy advisory firms actually make recommendations in a manner consistent with their public disclosures.[29]

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[27] The voting decisions of Charles Schwab, Neuberger, Loomis, and Invesco only differed in six cases. In these few cases of disagreement, we code the Glass Lewis SOP voting recommendation using the majority vote across these four funds. As a robustness check, we also coded these differences as missing and obtained virtually identical results.

[28] We were not able to construct the GL_against variable for 159 companies as the result of missing data in the N-PX filings of the target funds.

[29] Larcker, McCall, and Ormazabal (2012) find that the ISS public description regarding the metrics used to develop voting recommendations on stock option exchanges is highly consistent with their actual recommendations. Although this might be expected for a relatively simple compensation program, it is not clear whether similar consistency should be expected for the more complicated SOP recommendation.

Based on a reading of ISS and GL material in the public domain, the primary explanatory variable used in the SOP recommendation models is whether a compensation plan exhibits an appropriate relationship of pay-for-performance (*P4P*). Consistent with these disclosures, we construct *P4P* as an indicator variable that equals one (and zero otherwise) if (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* for companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is above the median compensation of the peer companies (the peer group is defined following ISS's criteria).[30] We compute CEO compensation in a manner similar to the ISS and GL guidelines. Specifically, CEO compensation is the sum of salary, bonus, all other compensation, change in the pension value and earnings from non-qualified deferred compensation, non-equity incentive plan payouts, and the grant date value of restricted stock and the Black-Scholes value of stock option grants. For our sample, 13% of the firms fail this pay-for-performance assessment (Table 2, Panel A).[31]

In addition to pay-for-performance (*P4P*), proxy advisors' voting policies include a variety of other criteria. While these additional inputs (e.g., tax gross ups) are very difficult to collect for a large sample, we develop five additional measures that are noted as part of the

[30] While both firms (and GL in particular) describe more complicated evaluation algorithms, they do not provide sufficient detail in their public disclosures for us to precisely replicate their approach. While a simplification, our *P4P* variable captures the essential features of the CEO's relative pay and performance described in the proxy advisor policies. As we show in this Section, *P4P* is significantly associated with the voting recommendations of both firms. However, the explanatory power is lower than would be expected if we were able to closely replicate their models.

[31] As a robustness check, we also construct variants of the pay-for-performance assessment. First, we exclude the condition that *TSR3Y* is lower than the median *TSR3Y* among the companies in the same GICS code. Second, we add the condition that total shareholders' returns in the last five years (*TSR5Y*) is lower than the median *TSR5Y* among the companies in the same GICS code. The results are similar, but weaker, partly because the latter condition induces some sample attrition (200 observations). We use the metric in the text because it is closest to the approach used by ISS and GL.

:rall evaluation process by proxy advisory firms. *PayDisparity* is the ratio between CEO npensation and the average compensation of the other named executive officers (NEOs). As sented in Table 2 (Panel A), the mean (median) ratio of CEO pay to average NEO pay is 2.76 51). *PctLTincentives* is the present value of long-term incentives divided by the sum of the sent value of both long term and short term incentives. We define long-term incentives as tricted stock, stock options, and incentive plan awards with a performance period greater than : year. Short-term incentives are incentive plan awards with a performance period of one yea ess. The mean (median) percentage of total incentives that is long-term in nature is 62% %). *PctPBincentives* is the present value of performance-based equity incentives divided by sum of the present value of both performance-based and non-performance-based equity entives. Performance-based equity incentives are performance-contingent stock options, tricted stock and stock unit awards, in which the number of shares and/or the vesting event is itingent upon the firms' performance. Consistent with proxy advisory assumptions, non-formance based equity incentives include restricted stock and stock options that are not itingent on company performance. The mean (median) ratio of performance-based to non-formance-based equity incentives is 32% (0%). *nPM* is the number of performance measures d in performance-based long-term incentives awarded to the CEO. The mean (median) nber of measures is 2.39 (2.00). Based on the public disclosures and commentaries by proxy isory firms, we expect *P4P*, *PayDisparity* to have a positive association with the probability eceiving a negative SOP recommendation, and *PctLTincentives*, *PctPBincentives* and *nPM* to e a negative association with the probability of receiving a negative SOP recommendation.

Proxy advisors can also include other factors into their recommendations that are not licly disclosed or difficult to quantify (e.g., "analyst expertise"). In an attempt to partially

address this measurement or model specification problem, we include two additional variables in our analysis. We measure ISS degree of concern about the firm's compensation practices using their compensation GRId score.[32] Specifically, *GRId_comp* equals one, two, or three if the compensation GRId score computed by ISS is labeled as "high risk", "medium risk", and "low risk", respectively. ISS considers 21% of our sample companies to be "high risk." We also measure an assessment of general governance practices using *WithholdRec* which is computed as the number of "withhold" or negative recommendations issued by ISS on directors of the company in the *previous* proxy vote. The mean (median) number of withhold recommendations is 0.13 (0.00).

4.3. Results

To test whether the SOP policies disclosed by proxy advisors are associated with their recommendations we estimate the following probit regressions:[33]

$$Against = \delta_0 + \delta_1\ P4P + \varepsilon, \tag{1a}$$

$$Against = \delta_0 + \delta_1\ P4P + \theta\ OtherCriteria + \varepsilon, \tag{1b}$$

where *Against* is either *ISS_against* or *GL_against* and *OtherCriteria* include *PayDisparity*, *PctLTincentives*, *PctPBincentives*, *nPM*, *GRID_comp*, and *WithholdRec*.

The estimation results for equations (1a) and (1b) are presented in Table 3 (Panel A and B show results of ISS and GL recommendations, respectively). The statistically positive coefficients of *P4P* in both panels indicate that proxy advisory firms rely on their stated pay-for-

[32] GRId (which stands for "Governance Risk Indicator") was the ISS rating system to assess governance risk in 2011. The GRId score provided one of three ratings ("Low Risk", "Medium Risk", and "High Risk") in four governance categories (Audit, Board, Compensation and Shareholder Rights). ISS stated that they measured "long-term governance risk," but did not provide further detail on exactly what governance risk is or what outcomes would be associated with that risk. We collect GRId scores from publicly available sources (e.g., http://finance.yahoo.com/) in June of 2011.

[33] Firm level subscripts have been suppressed throughout the text. Unless noted otherwise, all regressions are cross-sectional analyses. We also estimate equations (1a) and (1b) using logistic regressions and OLS and obtain very similar results.

performance criterion to issue SOP voting recommendations. However, the explanatory power for this *P4P* model is relatively modest (approximately 14% and 3% for ISS and GL, respectively). The marginal effects of *P4P* on *ISS_against* and *GL_against* are, respectively, 24% and 20%, which means that, on average, meeting the *P4P* criteria is associated with roughly a 20% increase in the probability of obtaining a favorable recommendation.

When other potential criteria for the voting recommendation are included in the specification, the explanatory power improves to approximately 21% and 9% for ISS and GL, respectively. As expected, we also find that *PayDisparity* and *WithholdRec* have positive coefficients for both the ISS and GL models. *GRID_comp* exhibits a negative coefficient, suggesting that the higher ISS rates the firm's compensation practices, the more favorable the SOP voting recommendation. As expected, the coefficient on *PctPBincentives* is negative, although not statistically significant. Thus, consistent with their public disclosures, pay-for performance and selected other criteria are statistically important determinants of the proxy advisory SOP recommendations. The results in Table 3 are important because they provide insight about what changes firms can make to reduce the probability of obtaining a negative recommendation.

5. Vote Outsourcing to Proxy Advisors

5.1 Shareholder voting outcomes

We compute the voting support of the SOP proposals (*PctSupport)* as the percentage of votes *in favor* of the SOP proposal based on each firm's reported voting outcomes. For example, some firms report percentage of votes in favor with respect to the sum of votes in favor and against, while other firms also include abstentions (exchange rules prevent broker non-votes from being counted as votes in favor of SOP, and they are typically excluded from the SOP

voting results altogether).[34] We also identify firms that failed to obtain a majority support for their SOP proposals using an indicator variable (*Fail*), that takes the value of one if *PctSupport* < 50% and zero otherwise. Most companies obtained a very high percentage of favorable votes for their initial SOP vote. Specifically, the mean (median) SOP proposal was backed by 90.6% (95.3%) of the votes. Only a small percentage (1.6%) failed to obtain majority support from shareholders (Table 2, panel A).

5.2 Proxy advisory firm influence

Boards of directors are likely to respond to proxy advisory firms only when they can actually influence substantial numbers of shareholder votes. If the firm has very limited institutional ownership, ISS and GL recommendations might be largely irrelevant to the board of directors.[35] Similarly, if institutional investors do not follow proxy advisory firm recommendations, these firms will have limited influence on the company. In order to incorporate these features into our analysis, it is necessary to develop a measure for the likely influence of proxy advisors on the voting by institutional shareholders for each firm confronting a SOP vote.

Using voting data from the ISS Voting Analytics database, we compute for each firm the expected percentage of institutional votes that will follow ISS voting recommendations (*ISS_influence*). We first calculate the proportion of times that each institution holding shares in a given firm votes with ISS when there is *disagreement* with management on any proposal from

[34] To compute the percentage support to shareholder proposals, 50.79% of our sample companies divide the number of votes in favor of the proposal by the sum of the votes in favor and against the proposal, 48.71% include the abstentions in the denominator, and 0.51% uses the total number of shares outstanding in the denominator. To ensure that our results are not sensitive to this cross-sectional variation in reporting voting results, we re-estimate equation (2) applying each one of these three ways of measuring voting support to all sample firms. Our inferences do not change.

[35] This statement may not be true if individuals comprise a large percentage of shareholders and they are influenced by proxy advisory firms. However, individuals do not generally have easy access to the ISS and GL SOP recommendations because they are not typically publicly disclosed and subscriptions to the reports may be expensive to individual who do not realize the compliance benefits of the proxy advisors.

2003 to 2010 in the ISS Voting Analytics database. We then collect the percentage ownership of the firm for each institution from the Thomson-Reuters Mutual Fund Holdings database of N30-D filings.[36] Finally, we multiply each institution's percentage ownership in the firm at the end of fiscal year 2010 by that institution's implied probability of voting with ISS if there is disagreement between the management and ISS. *ISS_influence* for a specific firm is the sum of the resulting measures across all institutions holding shares in that firm.

The mean (median) value of our measure of ISS influence is 8.84% (8.40%). This influence level is lower than the observed influence on the average vote outcome because not all users of proxy advisor services are captured in the cross section of the Voting Analytics and Thompson-Reuters databases. For example, pension funds or university endowments may subscribe to proxy advisors' services, but because they are not mutual funds, they are not required to report their voting record on Form NPX. Nonetheless, these values confirm that a sizable percentage of institutional votes follow ISS recommendations in cases of disagreement with management recommendations. In principle, it is possible to construct a similar influence measure for GL. However, since historical GL recommendations on all proposals are not available, we are not able to compute a similar GL influence measure.

We also use the percentage of firm shares owned by institutions (*PctInstit*) as alternative proxy for the influence of proxy advisors in the firm. We compute this variable collecting data from the Thomson-Reuters database of 13-F filings. Although this variable does not capture the propensity of institutional shareholders to follow proxy advisors' recommendations (because voting data is not publicly available for all institutions), it includes holdings by institutions other than mutual funds that could also be subject to proxy advisory influence.

[36] This database is also referred to as CDA/Spectrum S12 mutual fund holding database. The Spectrum data file contains information on quarterly equity holdings for mutual funds registered with the SEC.

5.3 Results

To assess the impact of ISS and GL on SOP votes, we estimate (using double-censored regression and the variables previously defined) various forms of the following general model:

$$PctSupport = \delta_0 + \delta_1 ISS_against + \delta_2 ISS_influence + \delta_3 ISS_influence \times ISS_against + \varepsilon. \quad (2)$$

The estimated intercepts in Table 4 (Panel A) show that firms with a positive recommendation from ISS and low ISS influence on institutional shareholders receive well in excess of 90% favorable votes. In column (1), the coefficient on *ISS_against* is −0.25 (t-stat. = −25.68) which suggests that a negative ISS recommendation decreases the percentage of favorable votes by about 25%. This estimate, along with the high explanatory power of this model (Pseudo R^2 = 49.21%) is consistent with the interpretation that ISS recommendations exert a substantial influence on SOP shareholder voting. However, the results in column (3) reveal that the effect of a negative recommendation significantly depends on the proxy advisor's influence on the company. Specifically, the interaction between *ISS_influence* and *ISS_against* is −0.01 (t-stat. = −6.67). This estimate suggests that, conditional on receiving a negative ISS SOP recommendation, two firms in the 25th and 75th percentile of *ISS_influence* (5.18 and 11.84, respectively) will exhibit a difference of 6.66% in voting support for their SOP proposals. Table 4 also shows that the results are similar when *PctInstit* is used as alternative proxy for proxy advisory influence, which suggests that it is unlikely that our inferences are confounded by measurement error in our measure of proxy advisory influence.

For reasons discussed above, we cannot estimate equation (2) using a direct measure of GL influence. However, we find that a negative GL recommendation is statistically associated with an 18% decrease in favorable SOP votes (Table 4, Panel B). When both ISS and GL recommendations are included in the model, both coefficients are negative and statistically

significant. The estimated coefficients suggest that when both ISS and GL have negative SOP recommendations, the favorable votes for SOP decrease by approximately 34%. Finally, when we use *PctInstit* as an indirect measure of GL influence, we find in column (3) that voting outcomes are increasingly negative when institutional ownership is higher. Overall, the results in Table 4 provide evidence that proxy advisory firm recommendations can substantially shift SOP votes.[37]

6. Board of Director Responses to Proxy Advisors Policies

6.1 Compensation changes before ISS recommendations

Using the discussion in Sections 2 and 4, we first identify compensation plan changes that are unambiguously viewed as positive practices in the context of the proxy advisory firm SOP voting policies. We exploit the fact that any new or substantially changed executive compensation plan must be publicly disclosed on SEC Form 8-K. This regulatory requirement provides an explicit announcement date for estimating excess returns associated with compensation plan changes.[38] An important advantage of this date is that 8-K filings only include the items or transactions being reported and the associated announcement date is less confounded with other information than periodic reports such as 10-Ks and proxy statements. However, since executive compensation changes are likely to be an outcome of board meetings, it is possible that the 8-Ks are confounded by other decisions being reported from the same meeting. For this reason, we limit our sample to 8-Ks that do not contain other non-

[37] In untabulated results, we also find that ISS influence increases the probability of failing to obtain majority support given a negative recommendation. Specifically, in a probit regression of *Fail* on *ISS_influence* for the firms that receive a negative ISS recommendation, we find that the coefficient on *ISS_influence* is 0.07 (t-stat. = 3.72). The marginal effect and the effect at the mean for *ISS_influence* are, respectively, 1.37% and 1.52%. Using the same subsample of firms, we also regress *Fail* on *GL_against*. The coefficient on *GL_against* is 1.74 (t-stat. = 4.51). The marginal effect and the effect at the mean for *GL_against* are, respectively, 28.6% and 24.41%. These results confirm that GL recommendations also determine the probability of failing the SOP proposal.

[38] Pursuant to the Form 8-K General Instructions (http://www.sec.gov/about/forms/form8-k.pdf), if an 8-K is required, it must be filed or furnished within four business days after the occurrence of the event.

compensation related information (discussed below). If these changes are induced by proxy advisors, the observed excess return can be interpreted as the impact of proxy advisory firm SOP policies and voting recommendations on shareholder value.

We collect compensation changes reported on form 8-K during the eight months prior to the 2011 proxy statement release date for our sample. This window was chosen for two reasons. First, changes in months closely following the prior year's annual meeting could be a response to the previous year's annual meeting and thus unrelated to future SOP considerations. Second, as most of our sample is comprised of firms with calendar fiscal year ends, the eight month window starts approximately at the same time as Dodd-Frank was signed into law (July, 2010).

Since we are interested in the market's reaction to compensation disclosures, we also exclude 8-Ks that include other important events such as executive hires or terminations and/or announcements related to other governance mechanisms (e.g. auditor changes or removal of a poison pill), which might confound our results.[39] To execute this data collection, we utilize a comprehensive database of 8-K filings from Equilar, Inc., which includes a categorization of the contents of each 8-K, allowing us to identify the subset of 8-K filings that meet our criteria. This selection procedure produces a sample of 733 8-Ks for our 2,008 firms, with 606 firms having at least one 8-K (the maximum number of 8-Ks for a single firm is three).

Each 8-K filing was read and compensation features that are unambiguously aligned with proxy advisor policies were identified. Specifically, we determine whether each 8-K discloses any of the following (see Appendix A for examples and the rationale for these choices): additional restrictions to equity plan(s) (10 observations), amendments to outstanding equity

[39] Because firms often aggregate compensation decisions (for instance, base salary, bonus and performance-based equity awards may be determined at the same time) it is not possible for us to confine the sample to only changes that are favored by proxy advisors. We utilize a sample of out-of-period filings to mitigate the concern that such decisions are confounding our results.

awards to add performance-based vesting or other holding requirements (1), new cash long-term incentive award(s) (21), reduction in CEO cash compensation (5), implementation of a clawback policy (6), amendments to change of control plan(s) (117), new performance-based equity award(s) (157), and reductions in executive perquisites and benefits (12). We construct the variable *PA_Aligned* ("PA" is shorthand for proxy advisor) as the number of these compensation changes announced in each 8-K. We set *PA_Aligned* equal to zero if either there are no 8-Ks in our sample or the compensation changes are not those we have identified as being unambiguously aligned with proxy advisor SOP policies. For our sample of 8-Ks, *PA_Aligned* equals three in 2 cases (0.27%), two in 28 (3.82%) cases, one in 267 (36.43%) cases and zero in 436 (54.48%) cases. It is important to note that the absence of a proxy advisor aligned feature does not necessarily imply that the compensation announcement in the 8-K would be viewed negatively in the proxy advisor models. Many common items, such as awarding of salary increases, determination of bonus payouts and determination of bonus performance objectives could be either good or bad in the context of the compensation and performance outcomes. Other items, such as minor amendments to plans or contracts to reflect tax or other legal changes may not enter into the evaluation.

Although the compensation changes used to construct *PA_Aligned* are considered desirable by proxy advisory firms, this does not necessarily imply that these changes are actually induced by ISS and GL. However, if these compensation changes are correlated with the likelihood that a firm will receive a negative SOP recommendation, this will provide some evidence that the changes are actually influenced by proxy advisors. The crucial assumptions for this interpretation are that the board of directors has a reasonable idea about the likely forthcoming SOP recommendation and that they believe that these changes during the time period prior to the

proxy statement release in order to improve the ultimate SOP recommendation produce a net economic benefit for shareholders. That is, the cost of changing the compensation plan is less than the cost of receiving substantial negative SOP votes. This assumed behavior is consistent with the results of the recent survey conducted by The Conference Board, the Stanford Rock Center, and NASDAQ (2012) which finds that most firms reviewed proxy advisor policies and that those policies influenced their ultimate compensation programs presented to shareholders for the SOP vote.

To explore this possibility we compare key characteristics for firms that make proxy advisor aligned compensation changes previous to the 2011 annual meeting to the remainder of the sample firms. Specifically, we focus on *P4P* because it is a primary determinant of the SOP recommendation (see Table 3) and *ISS_influence* because it (along with the SOP recommendation) has a substantial impact on shareholder voting (see Table 4). We also include *PctInstit* as alternative proxy for proxy advisory influence.

Table 5 (panel A) compares descriptive statistics of these variables for the 275 firms that filed 8-Ks disclosing proxy advisor aligned compensation changes in the 8 months before the proxy filing to the remaining 1,733 sample firms. We observe that there is a significantly higher proportion of firms that did not meet the *P4P* criterion among the firms that disclosed proxy advisor aligned compensation changes compared to the rest of sample firms. Table 5 also shows that, compared to the remainder of the sample, firms that disclosed proxy advisor aligned compensation changes exhibit higher levels of proxy advisory influence (measured by *ISSinfluence* and *PctInstit*). These results suggest that compensation changes desired by proxy advisors are more frequent in firms that are otherwise more likely to receive a negative SOP recommendation and where proxy advisors have substantial influence on shareholders.

Table 5 (panel A) also compares descriptive statistics of the previous variables between firms filing proxy advisor aligned 8-Ks and firms that filed compensation 8-Ks that did not contain any of the proxy advisor aligned characteristics. This analysis provides insight into the specific subsample of firms that we know have made changes that align their compensation with proxy advisor policies. Table 5 shows that the differences between these two groups are very similar to those described previously. These results reinforce the idea that not meeting proxy advisor's criteria leads to specific changes that are aligned with proxy advisor criteria, as opposed to a general set of compensation changes.

One important concern about the results in Table 5 (panel A) is that the identified pattern for compensation changes might be a usual phenomenon that occurs before every shareholder meeting, and thus not necessarily related to the SOP vote. To assess this concern, we take a random sample of 773 8-Ks from previous fiscal years (from 2006 to 2010) and examine whether this pattern of compensation-related 8-Ks is also found in previous years.[40] We then read and manually code each 8-K with the same criteria used for the 2011 sample of 8-Ks: additional restrictions to equity plan (7 observations), amend outstanding awards (0), new cash long-term incentive plans (29), reduction in cash compensation (22), clawback (6), changes/amendments to change of control plans (23), new performance-based equity plans (124), and reduce benefits (22). The most substantive difference between the two samples is the larger number of adjustments to change of control plans in the more recent time period. The most frequent change is the adoption of new performance-based equity plans in both time periods. For this random sample, *PA_Aligned* is greater than zero in 201 (27%) cases and zero in 532 (73%) cases. Thus, in the random sample from the 2006-2010 proxy seasons, there are substantially

[40] We code the randomization algorithm in a way that the random sample has the same number of 8-Ks every year and the same number of firms as the 2011 sample of 8-Ks.

fewer proxy advisor aligned 8-Ks than in the sample of 8-Ks from the 2011 proxy season (27.28% between 2006 and 2010 versus 40.51% in 2011).

In contrast to the results for the 2011 proxy season, *P4P* and *ISS_influence* are not significantly different between 8-Ks announcing proxy advisor friendly compensation changes and 8-Ks announcing other types of compensation changes. The results in Table 5 (Panel B) provide support for the interpretation that the time period prior to the first SOP vote exhibits unique compensation plan changes that are related to concerns about receiving a negative SOP recommendation from proxy advisors.

6.2 Compensation changes and subsequent ISS recommendations

Another crucial assumption for our claim that companies are making compensation plan changes in response to proxy advisors is that these changes should improve the chances of obtaining a more favorable recommendation. To provide some evidence on this issue, we examine whether making compensation changes that conform to proxy advisors' criteria decreases the probability of obtaining a subsequent negative SOP recommendation. We do this by estimating the following probit regression:

$$ISS_Against = \delta_0 + \delta_1 Sum_PA_Aligned + \delta_2 P4P + \varepsilon, \qquad (3)$$

where *Sum_PA_Aligned* is the sum of *PA_Aligned* (i.e., the total number compensation changes disclosed on 8-K during the eight months previous to the 2011 proxy statement that are aligned with proxy advisors' policies).[41] We include *P4P* as a control for the likely proxy advisory firm recommendation if there were no compensation changes by the firm (i.e., if a firm fails *P4P*, they are likely to obtain a negative SOP recommendation). We find that the coefficient on

[41] For the sample of firms, *Sum_PA_Aligned* equals three in five cases (0.25%), two in 44 (2.19%) cases, one in 226 (36.43%) cases and zero in 1733 (86.30%) cases. Note that *Sum_PA_Aligned* is measured at firm level, whereas *PA_Aligned* is measured at 8-K level. Thus, the distribution of *Sum_PA_Aligned* differs slightly from the distribution of *PA_Aligned* compensation because for some firms changes are announced in more than one 8-K.

Sum_PA_Aligned is statistically negative which suggesting that making compensation changes to align compensation programs with proxy advisors' policies reduces the probability of obtaining a negative SOP recommendation (Table 6).

The second set of columns in Table 6 presents results restricting the analysis to firms that actually made some type of compensation change. Specifically, we include the compensation-related 733 8-Ks and test whether the number of changes aligned with proxy advisory policies in each 8-K is associated with a subsequent favorable recommendation from proxy advisors. The results in Table 6 confirm that compensation changes conforming to ISS criteria lead to more favorable SOP recommendations.

6.3 Market reaction to compensation plan changes

To estimate the shareholder value implications of changes in compensation contracts made to comply with proxy advisor SOP voting policies, we examine the stock market reaction at the relevant 8-K filing date. If the threat of receiving a negative SOP recommendation from proxy advisors motivates the board of directors to remove features of compensation contracts that allow executives to extract rents, the market reaction to the announcement should be positive. Alternatively, if the influence of proxy advisor SOP policies motivates firms to deviate from existing optimal compensation contracts, we should observe a negative market reaction.

We examine the market reaction to compensation changes prior the proxy statement release on the day when the company files the 8-K announcing the change.[42] Our dependent variable, *AdjRet*, is the daily risk-adjusted return on the filing day for each firm computed using

[42] We analyze 8-Ks that contain only information on compensation changes in order to minimize the chances that the market reaction on that day is confounded by other information. We also examine the twenty 8-Ks with the largest negative reaction and search in Factiva for other potentially confounding information about the firm. We do not identify any informational events that are likely to confound our interpretation of the adjusted returns.

the standard daily Fama-French model plus momentum to compute daily risk-adjusted returns.[43] The coefficients of the risk factors are estimated using daily data over a period of -6 to +6 months around the filing date, and the incremental intercept on the 8-K announcement date is used as an estimate of *AdjRet*.

To test whether the stock market reaction to the introduction of compensation changes is associated with the desired criteria of proxy advisory firms, we regress risk-adjusted returns on *PA_Aligned:*

$$AdjRet = \delta_0 + \delta_1 \, PA_Aligned + \varepsilon \qquad (4)$$

In Table 7 (panel A, column 1), we find that the estimated coefficient for *PA_Aligned* is −0.444 (t-stat. = −2.91), whereas the intercept is not statistically different from zero (t-stat. = 0.86). This result is consistent with the conclusion that compensation changes desired by proxy advisory firms produce a net cost to shareholders, while compensation changes not related to proxy advisors' criteria are value-neutral.[44] The coefficient on *PA_Aligned* also suggests that the cost to shareholders of these changes is economically significant (the estimated average decrease in shareholder wealth is 44 basis points per induced change).[45] When we repeat this analysis using the random sample of 8-Ks from prior proxy seasons, we find (Table 7, panel A, column 2) that the adjusted returns for compensation changes aligned with proxy advisor policies are not statistically different from zero. (t-stat. = 0.21). Thus, the negative stock market reaction to proxy advisor aligned compensation changes is only observed in the time period just prior to the initial SOP vote. As shown in Table 7 (panel A, column 3), the estimated difference in adjusted returns is −0.488 (t-stat. = −1.91). These results suggest that the observed negative adjusted

[43] We obtain similar inferences calculating average risk-adjusted returns within a (0,+1) window around the filing.
[44] We also estimate the average adjusted return partitioning by *PA_Aligned*. The average adjusted return of 8-Ks where *PA_Aligned* is non-zero (zero) is negative and significant (.positive and not significantly different from zero).
[45] In untabulated results, we find similar results when value-weight the excess returns.

returns are not some type of general "8-K effect", but rather are associated with compensation changes made to obtain a favorable SOP recommendation from proxy advisory firms.[46]

A potential concern about these results is that, even in the absence of compensation changes, *PA_Aligned* could be related to daily returns if this variable captures an omitted risk factor or other determinants for cross-sectional returns. To address this concern, we examine whether the negative adjusted returns of firms that make compensation changes related to proxy advisors' criteria are unique to the 8-K filing date. Specifically, we compute the average daily adjusted return for the 30 days before and the 30 days after the 8-K filing date and partition the 8-K sample into those 8-Ks where *PA_Aligned* equals zero and those where *PA_Aligned* is non-zero.[47] We find that the average adjusted returns of firms that make proxy advisor aligned compensation changes are not systematically lower than those of firms that make compensation changes unrelated to those criteria before (Table 7, panel B, column 1) or after (Table 7, panel B, column 3) the 8-K filing date. Columns 4 and 5 of Table 7, panel B show that the negative return associated with proxy advisor aligned 8-Ks are unique to the 8-K filing date.[48]

6.4 Moving shareholder meeting dates in anticipation of SOP

[46] Another way to assess the impact of proxy advisor SOP recommendations is to examine the market reaction to contractual changes disclosed *after* receiving a negative SOP recommendation. We have identified a small sample of 12 cases where firms either made changes to their compensation programs or commitments to change future programs after filing their proxy statement in order to garner a positive ISS recommendation and avoid failing the SOP vote. The 12 companies are: Assured Guaranty Ltd., The Walt Disney Company, General Electric, Gannett Co., Lockheed Martin, Alcoa, Collective Brands, The Providence Service Corp, Intermec, Inc., Brandywine Realty Trust, MeadWestVaco, and Interline Brands, Inc. In untabulated results, we find that the average adjusted return within the (−1,+1) window around the day the changes were announced for these observations is −0.30% (t-statistic = −1.01). Although this sample size is small (and the power of the test is limited), this evidence is consistent with our prior results that compensation changes induced by proxy advisory firms have an adverse impact on shareholder value.

[47] We also repeat the test using shorter- and longer-windows around the 8-K dates and find consistent results.

[48] We also assess which individual compensation changes induce the most negative adjusted returns. The most common compensation changes are new performance-based equity awards (157 observations) and changes/amendments to change of control plans (117 observations). These two types of changes are associated with negative returns −0.551 and −0.103, respectively. New cash long-term incentive plans exhibit the largest adjusted return (−2.15), but there are only twenty one observations for this category. All types of compensation changes except for reductions in benefits are associated with negative risk-adjusted returns on the day of the announcement.

As discussed in Section 2, a formal SOP vote is required for most companies with shareholder meetings occurring on or after January 21, 2011. If revisions to compensation plans induced by SOP is costly to firms (or, alternatively, personally costly to executives), we should see companies with shareholder meetings in the first calendar quarter that appear likely to receive a negative SOP recommendation moving their annual meeting to before January 21st. We find that the number of firms having their meeting in the few days before January 21st increased dramatically from 2010 to 2011 (see Figure 1). In 2011, 37 companies decided to have their shareholder meeting on one of the four days before January 21st. In contrast, only 7 firms had their shareholder meeting on those days in 2010. Figure 1 also shows that the number of firms having their shareholder meeting on or shortly after January 21st is significantly lower in 2011 than in 2010. This concentration of shareholder meetings immediately before January 21st 2011 suggests that some firms advanced their meetings to avoid being subject to a SOP vote in 2011.

There are 194 firms in the Russell 3000 that had their meeting in the first calendar quarter of 2010. Interestingly, 32 of these firms had the 2010 shareholder meeting *after* January 21st 2010, but their 2011 shareholder meeting *before* January 21st 2011. In contrast, only 4 firms had their 2010 shareholder meeting *before* January 21st 2010, but their 2011 shareholder meeting *after* January 21st 2011. Moreover, we find evidence that the firms most likely to move their annual meeting date are those that are more likely to fail the *P4P* criterion. While 28.12% of the 32 firms that moved their meeting forward did not meet the *P4P* criterion, only 10.30% of the remaining 162 did not meet this criterion. This difference is statistically significant (t-stat. = 2.73), and is further evidence consistent with the idea firms view SOP legislation as costly.[49]

[49] One of the potential costs of failing to obtain the required support for SOP proposals is that the firms and board members can be sued on grounds of alleged breach of fiduciary duty. After the 2011 proxy season, seven companies

6.5 Alternative interpretations of the results

Performance Signaling

One alternative interpretation of our results is that the market reacts negatively to the announcement of these compensation changes not because the recontracting is suboptimal, but because the change signals poor future performance or is indicative of other governance problems that the market was unaware of. For example, boards might introduce contractual changes because they possess inside information that firm performance will be worse than expected and as a result they impose compensation risk (e.g., performance-based equity) on managers in an attempt to change incentives and future performance. In this setting, the market would interpret the observed recontracting as a negative signal, and this has the potential to confound our conclusion that compensation changes induced by proxy advisors are value decreasing for shareholders.

Although signaling is a plausible alternative interpretation, the available empirical evidence does not support this conclusion. Specifically, prior literature has shown that firms adopting performance-based equity programs have historically realized positive future performance. For example Larcker (1983) finds a positive market reaction to the introduction of performance-based plans and Bettis, Bizjak, Coles, and Kalpathy (2010) find that companies that introduce performance-based features in compensation contracts have lower past stock price performance and significantly better subsequent operating performance than control firms. This

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which experienced a SOP voting failure were sued shortly after the shareholder meeting. To the extent that the voting outcome and the subsequent lawsuits were (at least partially) unexpected by the market and the lawsuits are viewed as costly (e.g., either through direct costs related to the suit or the costs associated with management distraction), the market reaction to these events can also provide some insight into the cost implications of the SOP voting recommendations. In untabulated results, we find that the stock market reaction for firms involved in a SOP lawsuit is −0.50% (t-stat. = −1.58). Although this result should be interpreted cautiously because of the small number of observations (and reduced statistical power), it suggest that a negative SOP recommendation and a subsequent voting failure can impose substantial costs on affected.

evidence suggests that the adoption of performance-based equity plans (if anything) should be a signal of future good performance, as opposed to bad performance.

To provide further evidence on this point, we estimate a regression of future firm performance (calculated as the average of quarterly earnings deflated by total assets over the four quarters ending after the filing date of the 8-K) on the explanatory variables in equation (4). In untabulated results, we find that the coefficient on *PA_Aligned* is *positive* and not statistically significant (t-stat. = 0.59). This result is not consistent with the negative signaling explanation.

Another related way to provide insight into the signaling story is to examine the timing of the 8-K filings. As discussed in Section 2, shareholder return, measured at the end of the firms' fiscal year, is the primary measure of firm performance used by proxy advisory firms. Our analysis, on the other hand, considers 8-Ks filed in the 8 months prior to the proxy statement filing date, which is typically three to four months after the fiscal year end. As a result, 84.5% of our proxy advisor aligned 8-K observations occur *after* the fiscal year end when the relevant market returns are already known. If our findings were driven by a negative signaling effect, the negative reaction should be concentrated in the observations *prior* to the fiscal year end. However, out of the 297 filings with a potential SOP recommendation problem (i.e., where the variable *PA_aligned* = 1), only 46 are filed *before* the fiscal year end date, and the average risk-adjusted return for these 8-Ks is a statistically insignificant −0.27% (t-stat. = −1.17). In contrast, the average risk-adjusted return of the 251 changes announced *after* the fiscal year end is a statistically significant −0.35% (t-stat = −1.90).[50] These results suggest that the negative reaction is concentrated in 8-Ks filed *after* the fiscal year end, and thus the contractual change does not appear to be signaling negative performance for this fiscal year.

[50] In contrast, for the subset of 8-Ks with *PA_aligned* = 0 only 73 are filed *after* the fiscal year end date. The average risk-adjusted returns of 8-Ks filed both before and after the fiscal year end are positive, but not statistically significant.

Market Expectations of Compensation Changes

Our interpretation of the negative risk-adjusted return associated with compensation changes induced by proxy advisors is that unexpected and unfavorable information is released to the market at the 8-K announcement date. However, a concern with this explanation is that investor expectations about proxy advisor and board behavior are unknown. Conceptually, the observed risk-adjusted return should be the difference between the value of the observed change and the value of the compensation change (if any) expected by the market. This means that the market must have an expectation about the value of a future compensation change and the probability that this change will occur. Moreover, both of these variables are likely to be influenced by the probability that the proxy advisory firm will make a negative recommendation, expected costs of having a substantial number of against votes, and expected cost of changing the compensation program. There are several reasons to believe that this is an especially difficult inference problem for the market.

One complicating factor is that the market must develop an accurate expectation about proxy advisor recommendations *prior* to the 8-K filing event, which is (by construction) prior to the proxy statement. As we show in Table 3, it is very difficult to infer the proxy advisor recommendations even after considering a substantial portion of information that is available in the proxy statement. At the time of the 8-K, there is considerably less information available for investors to make an inference (for instance, proxy advisors evaluate the quality of proxy statement disclosures, which is not known until the proxy statement is actually filed). This raises serious questions about the market's ability to reasonably forecast proxy advisory firm SOP recommendations.

Even if the market can develop an accurate forecast for the recommendation, it is still necessary to estimate the expected costs of negative votes and the valuation of changes in the compensation plan which would lead to positive vote. It may be reasonable to assume that litigation costs or management distraction can be assessed by the market. However, private costs such as reputational concerns associated with a negative voting outcome and the expected costs (or benefits) resulting from a compensation change are likely to be very difficult for the market to assess. Thus, although not completely satisfactory from a pure theoretical perspective, we believe that as a practical matter the market's expectation for changes at the 8-K announcement date are likely to be quite diffuse.

Holding aside this conjecture about market expectations, it is possible that the market correctly anticipates that the firm will be exposed to the influence of the proxy advisors. Moreover, proxy advisor policies may be value increasing to shareholders, but the market is disappointed by the changes observed at the 8-K announcement (i.e., the changes do not "go far enough" to address compensation problems at a firm). In this scenario, we should observe a negative market reaction even though this outcome has nothing to do with suboptimal compensation changes being induced by proxy advisory firms.

The difficulty with this alternative interpretation is that it is based on a market that has biased expectations for SOP responses by firms. As discussed above, we expect the market to be faced with considerable difficulty in estimating the influence of proxy advisors, but there is no obvious reason for the market to make systematically biased estimates of expected compensation changes by firms. Moreover, under this interpretation the most negative market response should be observed for firms that exhibit pay-for-performance concerns ($P4P = 1$) and have 8-K announcements with compensation changes that are *not aligned* with proxy advisor policies. In

untabulated results, we find a statistically insignificant positive mean risk-adjusted return for this subset of firms (t-stat. = 0.07). Thus, we do not believe that the interpretation of our results is completely confounded by economic issues related to market expectations.

Rent-Extracting Compensation Changes

It is also possible that the compensation changes are being made by rent extracting managers seeking to avoid market discipline that may be imposed on them after the SOP vote. For example, as illustrated in Table 6, the proxy advisor aligned changes reduce the likelihood of a negative recommendation and receiving a positive recommendation ensured a passing SOP vote. If boards and managers making compensation changes are actually engaging in rent extraction and the market correctly anticipates that they have reduced the likelihood of facing market discipline by conforming to proxy advisor policies, the market would be expected to reduce the value of the firm. Although the mechanism by which the shareholders are harmed is different than our interpretation, we reach the same conclusion that the proxy advisor policies are not value increasing for shareholders.

7. Summary and Concluding Remarks

Institutional investor voting on corporate proxies has the potential to influence a wide range of firm corporate governance choices. Over the past decade, the SEC and Congress have increased regulation focused on institutional investors voting. An explicit assumption in this regulation was that institutional investors would conduct the research necessary to vote in a manner that would maximize value for all firm shareholders. Unfortunately institutional investors face a classic free rider problem in conducting this research and may not have economic incentives to make such an investment. A significant proportion of institutional investors rely on proxy advisory firms to conduct research and determine votes on their behalf.

This outsourcing of voting responsibilities can be an efficient means of sharing the costs of research across investors. However, if the free rider problems sufficiently dilute the benefits to individual institutions, it is also plausible that the outsourcing of voting responsibilities to institutional investors represents the lowest cost voting compliance mechanism. In such a setting investors are unwilling to pay more for better research into optimal vote decisions because their vote is not expected to have an impact on the voting outcome and there is no additional benefit such as using the research to impact the stock selections made by portfolio managers.

The fundamental question is whether outsourcing votes to proxy advisors creates or destroys value for firm shareholders. This is important in the current environment because, unlike the individual institution which may only control a small block of shares, proxy advisors aggregate a large block of votes which will follow their recommendations (34% on average for our sample). As such, proxy advisors can be pivotal in the outcome of a given ballot item and induce firms to make governance changes in response. If these voting recommendations are optimal, changes in firms induced by these policies will improve firm governance and benefit shareholders. However, if the policies are arbitrary and/or not optimal, they may induce boards of directors to change to less appropriate governance structures.

We examine the shareholder value implications of outsourcing to proxy advisory firms on the recent requirement to implement Say-on-Pay. Using a large cross-section of firms, we confirm that proxy advisory firm recommendations have a substantive impact on SOP voting outcomes. We also find that, anticipating this impact, a significant number of boards of directors change their compensation programs in the time period *before* the formal shareholder vote in a manner that better aligns compensation programs with the recommendation policies of proxy advisory firms and subsequently realize a higher likelihood of a positive vote recommendation.

We interpret our result as evidence that boards of directors change executive compensation plans in order to avoid a negative SOP recommendation by proxy advisory firms, and thereby increase the likelihood that the firm will not fail the vote (or will garner a sufficient level of positive votes). The stock market reaction to these compensation program changes is statistically *negative*. Moreover, this effect is unique to the time prior to the initial SOP vote (2011) and a similar stock market reaction is not observed during the 2006-2010 time period.

As with all observational studies, there are a variety of alternative interpretations of this result. However, we believe the most parsimonious and plausible conclusion is that the confluence of free rider problems in the voting decision, regulation of voting in institutional investors, and the decision by the SEC to regard proxy advisor policies as appropriate for purposes of institutional investor compliance with regulation has led to policies of proxy advisory firms that induce the boards of directors to make compensation decisions that *decrease* shareholder value. While our findings provide insight into the shareholder value implications of outsourcing proxy research in the current economic and regulatory setting, we acknowledge that we cannot make inferences about the social welfare implications of the current regulatory regime relative to alternatives such as a prohibition on proxy advisory firms or a reduction in items presented to shareholders for vote.

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Appendix A. Compensation changes aligned with proxy advisor' voting policies

Feature	Description	Rationale
New Performance-Based Equity Plan	The award of equity compensation (stock options, restricted stock or restricted stock units) in which the vesting event and/or the number of shares earned is contingent on the achievement of pre-determined performance objectives where comparable awards were not granted in the prior fiscal year.	ISS' policies explicitly consider the performance-based vs. non-performance-based pay ratio. Equity awards that do not have performance contingencies are not considered performance-based (ISS 2011a). GL views the lack of performance-based long-term incentives as a concern which was cited in 41% of its negative recommendations.
New Cash Long-Term Incentive Plan	Award of new cash bonus opportunities in which the bonus is earned based on the achievement of performance objectives measured over a period greater than one year where comparable awards were not granted in the prior fiscal year.	ISS' policies explicitly consider the performance-based vs. non-performance-based pay ratio. Equity awards that do not have performance contingencies are not considered performance-based (ISS 2011a). GL views the lack of performance-based long-term incentives as a concern which was cited in 41% of its negative recommendations. Also, because cash-based plans are included as compensation when they are *earned* rather than when they are *awarded* in both the ISS and GL computations of pay, a new long-term cash plan will reduce pay in the current year relative to a comparable equity award.
Restrict Existing Equity Plan(s)	Amendments to existing equity compensation programs that restrict or eliminate features that are in the approved plan, including mandating minimum vesting periods, prohibiting stock option repricing without shareholder approval and reducing the number of shares available for grant under the plan.	ISS and GL oppose stock option repricings conducted without shareholder approval (Larcker, McCall, and Ormazabal, 2012). GL indicates that equity awards should be subject to minimum vesting period (Glass Lewis 2011a). Both ISS and GL measure equity plans using proprietary measures of the total plan dilution, which includes both outstanding equity awards and awards that can be granted under the plan (ISS 2011a, Glass Lewis 2011a).
Amend Outstanding Equity Awards	Amendments to previously awarded equity that are not advantageous to the recipient, including extending vesting periods, adding shareholding requirements and adding performance conditions to the awards.	Neither ISS nor GL consider stock options or restricted shares with time-based vesting to be performance-based. Both ISS and GL view stock ownership guidelines and holding requirements as good compensation practices (ISS 2010, Glass Lewis 2011a).

Appendix A. Compensation changes aligned with proxy advisor' voting policies (cont'd)

Feature	Description	Rationale
Eliminate "Poor" Features From Change in Control Agreements	Amendment of existing agreements or the disclosure of new agreements that eliminate excise tax gross-ups or that eliminate single-trigger provisions (that provide payment to an executive without that executive having been involuntarily terminated).	Both ISS and GL oppose excise tax gross-ups and single trigger agreements (ISS 2011a, Glass Lewis 2011a).
New Clawback Arrangement	Implementation of a "Clawback" policy, which provides for recoupment of compensation if it is deemed to have been inappropriately earned (e.g., due to restatement).	ISS examines whether a firm has a Clawback policy as part of its Compensation Committee Communication & Effectiveness evaluation. GL considers Clawback policies a "best practice" (Glass Lewis 2011a) and highlighted the lack of a Clawback policy in a significant number of their negative recommendations (Ertimur, Ferri, and Oesch, 2013).
Reduction or Elimination of Executive Benefits	A reduction in or elimination of benefits or perquisites available only to senior executives(e.g., use of corporate aircraft, automobile payments, financial planning, supplemental retirement plans and supplemental insurance plans). Also includes the elimination of tax gross-up payments associated with executive benefits.	The value of executive benefits is captured in the computation of compensation for both ISS and GL. ISS provides detailed review of executive benefits in its Non-Performance-Based Pay Elements analysis (ISS 2011a). Both ISS and GL oppose the payment of taxes due to executives for the receipt of benefits (ISS 2011a, GL 2011a).
Reduction in CEO Cash Compensation	A reduction to the CEO's salary or to the target bonus opportunity.	Both ISS and GL compare a firms CEO pay levels and firm performance to industry peers in order to determine the pay/performance alignment under their proprietary analyses. For poor performers, one way to align the pay with performance is to reduce the level of pay.

Appendix B. Example disclosures of compensation changes aligned with proxy advisor' voting policies

New performance-based equity plan:

"The final component of the 2011 equity awards consists of performance units. Fifty percent (50%) of the performance units will vest on March 15, 2013, and the remaining fifty percent (50%) will vest on March 17, 2014, subject to the provisions of the Performance Unit Award Agreement. The number of performance units awarded will be adjusted based on the achievement of RONOA (our Adjusted Operating Income divided by the sum of average Property, Plant and Equipment, average Goodwill and Other Intangible Assets, and average Operating Working Capital). RONOA will be measured for the period beginning on January 1, 2011, and ending on December 31, 2012. Target RONOA is 10.0%."

Source: Boise Inc. SEC Form 8-K, March 18, 2011.

New cash long-term incentive plan:

"SUPERVALU INC. (the "Company") finalized a long-term incentive program for the Fiscal 2012-2014 performance period pursuant to which participants, including the Company's named executive officers, will be eligible to receive incentive compensation based on the increase in the Company's market capitalization during the performance period, if any, using a fixed number of common shares outstanding. The maximum amount of increase in the Company's stock price is capped at $25, and the maximum percent of the increase in market capitalization that will be paid to all participants will be 4.8% of such increase. The Company's top 800 employees will be eligible for a share of the payments, if any, under the program. The program provides for a minimum, performance-based payout opportunity equal to 25% of the target award value assuming $5.7 billion or more of EBIDTA is generated over the three-year performance period. Payments under the program, if any will be made half in cash and half in shares of the Company's stock following the end of the performance period. The three-year measurement period aligns with the estimated time to fully realize the business transformation currently underway at the Company."

Source: SUPERVALU INC., SEC Form 8-k, April 28, 2011.

Restrict existing equity plan(s):

"Termination of Option Buyout Provisions in Equity Plans. On January 28, 2011, the Board of Directors of The Progressive Corporation (the "Company") approved the Third Amendment to The Progressive Corporation 2010 Equity Incentive Plan (the "Plan") and the Third Amendment to The Progressive Corporation 2003 Incentive Plan (together, the "Amendments," copies of which are attached hereto as Exhibits 10.1 and 10.2, respectively). Under each of these plans, prior to the Amendments, the Company had the authority to buyout certain outstanding stock option awards (and, in the case of the 2010 Equity Incentive Plan, stock appreciation rights), on terms and conditions acceptable to the Compensation Committee of the Board of Directors. In each case, the Amendments have modified the applicable plan to terminate the Company's authority to buyout such outstanding stock options and stock appreciation rights."

Source: The Progressive Corporation, SEC Form 8-K, filed February 2, 2011.

Amend outstanding equity awards:

"On October 29, 2010, SYNNEX Corporation ("SYNNEX") amended the restricted stock unit award (the "RSUs") granted to each of Dennis Polk, SYNNEX' Chief Operating Officer, and Peter Larocque, SYNNEX' President, U.S. Distribution (each, an "Officer"). Subject to certain conditions, the RSUs will continue to vest in full on the fifth anniversary of April 29, 2010 (the "Original Grant Date"). A portion of the RSUs will vest upon the fourth and fifth anniversary of the Original Grant Date provided that the Officer remains in continuous employment by SYNNEX through the vesting date. An additional portion of the RSUs will vest on the fourth and fifth anniversary of the Original Grant Date provided, that (i) the Officer remains in continuous employment by SYNNEX through the vesting date and (ii)(A) on the fourth anniversary of the Original Grant Date, SYNNEX achieves on a cumulative basis, 5% compound annual growth rate ("CAGR") in earnings before income and taxes ("EBIT") from continuing operations in fiscal years ending November 30, 2011 through 2013, and (B) on the fifth anniversary of the Original Grant Date, SYNNEX achieves on a cumulative basis, 5% CAGR in EBIT from continuing operations in fiscal years ending November 30, 2011 through 2014. In the event of an Officer's death prior to the fifth anniversary of the Original Grant Date, SYNNEX will transfer to such Officer's estate the number of shares that would have vested on an annual basis on or prior to such Officer's death. The amended form of stock unit agreement is filed herewith as Exhibit 10.1."

Source: SYNNEX Corporation, SEC Form 8-K filed November 4, 2010.

Appendix B. Example disclosures of compensation changes aligned with proxy advisor' voting policies (cont'd)

Eliminate "poor" features from change in control agreements:

"The existing employment agreements were amended and restated to:

- *extend the term of the agreements for one year, to June 22, 2014 in the case of Mr. Bordelon and to June 22, 2013 in the case of the Executive Vice Presidents;*
- *remove the prior provisions that permitted the agreements to be automatically extended for an additional year on the annual anniversary date of the agreement unless either party to the agreement has given notice that the term will not be extended (commonly referred to as an "evergreen" provision); and*
- *revise the provision in Mr. Bordelon's agreement with the Company which requires the Company to (1) reimburse Mr. Bordelon for any 20% excise tax incurred under Section 280G of the Internal Revenue Code of 1986, as amended ("Section 280G"), upon severance of employment after a "change-in-control", as defined under Section 280G, and (2) pay the additional federal, state and local income taxes and excise taxes on such reimbursement in order to place Mr. Bordelon in the same after-tax position he would have been in if the excise tax had not been imposed (commonly referred to as a "Section 280G gross-up" provision) such that the Company will be obligated to pay a Section 280G gross-up to Mr. Bordelon only with respect to a change-in-control which occurs on or before June 22, 2014.*

The determination to remove the evergreen provisions in the agreements and, in the case of Mr. Bordelon's agreement with the Company, limit the provision providing for a 280G gross-up payment to change-in-control transactions occurring on or before June 22, 2014, were undertaken primarily upon consideration of the governance risk indicators ("GRId") published by RiskMetrics Group (formerly known as Institutional Shareholder Services or "ISS"). The Company has taken other actions related to its GRId score, including the adoption of chief executive officer and director stock ownership guidelines and of a compensation clawback policy."

Source: Home Bancorp, Inc., SEC Form 8-K filed March 30, 2011.

New clawback arrangement:

"On March 18, 2011, the Board of Chelsea adopted a recoupment policy that requires all executive officers to repay or return cash bonuses and/or equity awards in the event: (i) the Company issues a material restatement of its financial statements and where the restatement was caused by the employee's intentional misconduct; (ii) the executive officer was found to be in violation of non-compete provisions of any plan or agreement; or (iii) the executive officer has committed ethical or criminal violations."

Source: Chelsea Therapeutics International, Ltd., SEC Form 8-K filed March 18, 2011.

Reduction or elimination of executive benefits:

"On December 1, 2010, Mueller Water Products, Inc. (the "Company") and Gregory E. Hyland, the Company's Chairman of the Board of Directors, President and Chief Executive Officer, entered into an amendment (the "Amendment") to Mr. Hyland's employment agreement (the "Agreement"). The Amendment deletes a provision from the original Agreement that entitled Mr. Hyland to reimbursement for membership dues in one country club and one luncheon club in the Atlanta, Georgia area. The Amendment is consistent with a recent determination by the Company's Compensation and Human Resources Committee to modify the Company's policy for executive club reimbursement, such that the Company will no longer reimburse executives for club membership fees."

Source: Mueller Water Products, Inc., SEC Form 8-K, filed December 6, 2010.

Reduction in CEO cash compensation:

"On February 3, 2011, following the recommendation of the Compensation Committee of the Board of Directors (the "Board") of Intuitive Surgical, Inc. ("Intuitive" or the "Company"), the Board approved a decrease of $100,000 in the base salary for Lonnie Smith, the Company's executive officer as well as the Chairman of the Board. Mr. Smith's new base salary, effective January 1, 2011, will be $100,000 and he will not participate in the Company's bonus plan."

Source: Intuitive Surgical, Inc., SEC Form 8-K filed February 3, 2011.

Figure 1. Distribution of shareholder meeting dates

Figure 1 presents the distribution of annual shareholder meetings in a window around January 21st (day 0) in both 2010 and 2011. Say on pay is required under Dodd-Frank at annual meetings on or after January 21st, 2011. The vertical axis indicates the number of companies that had the annual meeting that day. The horizontal axis indicates the number of days before or after January 21st. For example "−4" means 4 days before January 21st and "4" means 4 days after January 21st. The darker bars refer to meetings in 2010 and the lighter bars to meetings in 2011.

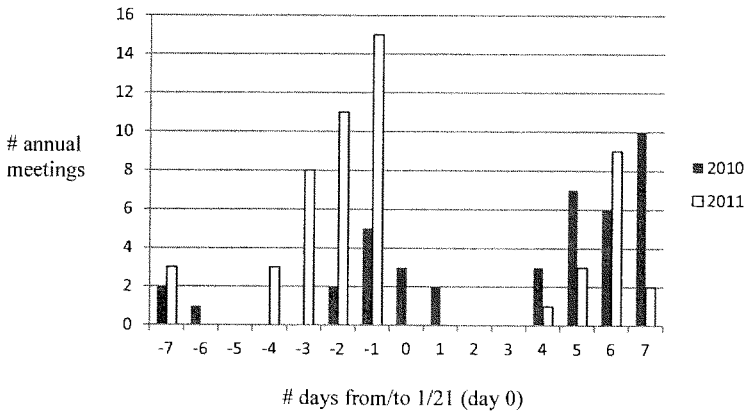

Table 1. Descriptive statistics for the sample firms

This table reports selected descriptive statistics for our sample of 2,008 firms and the 4,513 benchmark firms in the Compustat-CRSP universe with fiscal year end date between 6/30/2010 and 3/31/2011. Panel A presents descriptive statistics of variables related to firm characteristics. *Size* is the firm's equity market value (in millions of dollars). *BM* is the Book-to-market ratio. *Leverage* is total liabilities divided by total assets. *Volatility* is the annualized return volatility, computed as the standard deviation of daily returns over 365 days prior to fiscal year end. *ROA* is return on assets (operating income scaled by total assets). *Pctinstit* is the percentage of the firm's shares owned by institutions. Panel B presents the industry distribution of the sample and Compustat firms using Fama and French industry classification.

Panel A. Descriptive Statistics

	Sample		*Compustat*	
Firm characteristic	*mean*	*median*	*mean*	*median*
Market Cap (millions)	5,982	1,173	3,750	499
BM	0.57	0.51	1.09	0.60
Leverage	0.22	0.17	0.20	0.14
ROA	0.06	0.07	0.07	0.05
Volatility	0.40	0.37	0.48	0.42
Pctinstit	0.72	0.78	0.51	0.55

Panel B. Industry Sectors

Fama and French 12 industry groups	*Sample*	*Compustat*
Business equipment	17.13%	13.45%
Chemicals and allied products	2.19%	2.34%
Consumer durables	2.02%	2.09%
Oil, gas, and coal extraction and products	5.14%	5.13%
Healthcare, medical equipment and drugs	10.86%	10.41%
Manufacturing	8.62%	10.46%
Financial firms	22.71%	23.66%
Consumer nondurables	4.30%	4.13%
Other	13.34%	12.20%
Wholesale, retail, and some services	7.73%	8.67%
Telephone and television transmission	3.08%	3.14%
Utilities	2.88%	4.33%

Table 2. Descriptive statistics for measures used in the analyses

This table reports descriptive statistics for the measures used in subsequent analyses for our 2,008 sample firms. *ISS_against* equals one if ISS recommended against and zero otherwise. *GL_against* equals one if Glass Lewis recommended against and zero otherwise. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if: (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is above the median compensation of the peer companies (the peer group is defined following ISS's criteria). *PayDisparity* is the ratio between CEO compensation and the average compensation of the other named executive officers (NEO's). *PctLTincentives* is the present value of long-term incentives divided by the sum of the present value of both long term and short term incentives. *PctPBincentives* is the present value of performance-based equity incentives divided by the sum of the present value of both performance-based and non-performance-based equity incentives. *nPM* is the number of different performance measures used by the LTIP's, stock and option grants to the CEO. *GRID_comp* equals one if the compensation GRId score computed by ISS is labeled as "high concern", two if it is labeled as "medium concern" and three if it is labeled as "low concern". *WithholdRec* is the number of "withhold" or negative recommendations issued by ISS on directors of the company in the previous proxy season. *PctSupport* is the percentage of favorable advisory votes on SOP. *Fail* equals one if the SOP proposal failed to obtain majority support and zero otherwise. *ISS_influence* is calculated as the sum across funds in that company of the probability of voting with ISS conditional on disagreement multiplied by the holdings of each fund in the company.

Panel A. Variables used in subsequent analyses

	25th pct	*mean*	*median*	*75th pct*
SOP voting recommendations				
ISS_against	0	0.13	0	0
GL_against	0	0.21	0	0
Proxy advisors' SOP policies				
P4P	0	0.13	0	0
Paydisparity	1.88	2.76	2.51	3.35
PctLTincentives	0.51	0.62	0.73	0.83
PctPBincentives	0	0.32	0	0.71
nPM	1	2.39	2	4
Other variables				
GRID_comp	2	1.97	2	2
WithholdRec	0	0.13	0	0.08
Voting outcomes				
Pctsupport	0.87	0.90	0.95	0.98
Fail	0	0.016	0	0
Measure of ISS influence				
ISS_influence (in %)	5.18	8.85	8.40	11.85

Panel B. ISS and GL recommendations

	Only ISS		*Only GL*		*ISS and GL*			
ISS recommendation	*For*	*Against*	-	-	*For*		*Against*	
GL recommendation	-	-	*For*	*Against*	*For*	*Against*	*For*	*Against*
Pass (PctSupport ≥ 50%)	1,747	229	1,462	357	1,339	271	123	86
Fail (PctSupport < 50%)	0	32	1	29	0	0	1	29
#firms	1,747	261	1,463	386	1,339	271	124	115

Table 3. Proxy advisors' SOP Recommendations

This table reports results of probit regressions testing the determinants of ISS SOP recommendations. Panel A and panel B analyze the determinants for ISS and Glass Lewis recommendations, respectively. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if:(i) the CEO's compensation increases from 2009 to 2010,(ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is above the median compensation of the peer companies (the peer group is defined following ISS's criteria). *PayDisparity* is the ratio between CEO compensation and the average compensation for the other named executive officers (NEOs). *PctLTincentives* is the present value of long-term incentives divided by the sum of the present value of both long term and short term incentives. *PctPBincentives* is the present value of performance-based equity incentives divided by the sum of the present value of both performance-based and non-performance-based equity incentives. *nPM* is the number of different performance measures used by the LTIP's, stock and option grants to the CEO. *GRID_comp* equals one if the compensation GRId score computed by ISS is labeled as "high concern", two if it is labeled as "medium concern" and three if it is labeled as "low concern". *WithholdRec* is the number of "withhold" or negative recommendations issued by ISS on directors of the company in the previous proxy season. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. ISS recommendations

	Expected	*ISS_against*		*ISS_against*	
Variable	Sign	coef	*t*-stat	coef	*t*-stat
Constant		−1.41***	−32.14	−1.04***	−6.51
P4P	+	1.30***	14.71	1.30***	14.04
PayDisparity	+			0.13***	5.08
PctLTincentives	-			0.04	0.29
PctPBincenties	-			−0.03	−0.35
nPM	-			−0.06***	−2.72
GRID_comp	-			−0.35***	−5.40
WithholdRec	+			0.50***	3.72
Pseudo R^2			13.87%		20.75%
N			2,008		2,008

Panel B. GL recommendations

	Expected	*GL_against*		*GL_against*	
Variable	Sign	coef	*t*-stat	coef	*t*-stat
Constant		−0.92***	−25.24	−1.43***	−8.85
P4P	+	0.71***	7.98	0.58***	6.37
PayDisparity	+			0.17***	6.94
pctLTincentives	-			0.61***	4.64
pctPBincenties	-			−0.04	−0.41
nPM	-			−0.01	−0.49
GRID_comp	-			−0.19***	−3.20
WithholdRec	+			0.15	1.15
Pseudo R^2			3.30%		8.52%
N			1,849		1,849

Table 4. Proxy advisors' SOP Recommendations and Voting Outcomes

This table reports results of the association between voting outcomes ISS SOP recommendations and ISS recommendations. Panel A presents results of the cross-sectional determinants of voting support. *PctSupport* is the percentage of favorable advisory votes on SOP. *ISS_influence* is calculated as the sum across funds in that company of the probability of voting with ISS conditional on disagreement multiplied by the holdings of each fund in the company. *PctInstit* is the percentage of shares owned by institutions. *ISS_against* equals one if ISS recommended against the company's compensation practices and zero otherwise. Panel B compares the influence of recommendations by ISS and GL on voting support. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. Influence of ISS on voting support

Dep. Var: PctSupport	*(1)*		*(2)*		*(3)*		*(4)*	
Variable	coef	*t*-stat	coef	*t*-stat	coef	*t*-stat	coef	*t*-stat
Constant	0.93***	568.18	0.96***	267.28	0.95***	300.96	0.96***	196.51
ISS_against	−0.25***	−25.68	−0.25***	−26.63	−0.15***	−9.07	−0.08***	−2.89
ISS_influence			−0.002***	−7.19	−0.001***	−3.98		
*ISS_against*ISS_influence*					−0.01***	−6.67		
PctInstit							−0.04***	−5.61
*ISS_against*PctInstit*							−0.24***	−6.36
Pseudo R^2		49.21%		50.66%		53.16%		53.77%
N		2,008		2,008		2,008		2,008

Panel B. Influence of GL on voting support

Dep. Var: PctSupport	*(1)*		*(2)*		*(3)*	
Variable	coef	*t*-stat	coef	*t*-stat	coef	*t*-stat
Constant	0.94***	460.74	0.96***	771.07	0.94***	160.67
GL_against	−0.18***	−22.88	−0.13***	−24.34	−0.10***	−3.65
ISS_against			−0.21***	−24.62		
PctInstit					−0.01	−1.42
*GL_against*PctInstit*					−0.09**	−2.55
Pseudo R^2		35.66%		69.16%		36.32%
N		1,849		1,849		1,849

Table 5. Characterization of compensation changes preceding the annual meeting

Panel A presents descriptive statistics of selected characteristics of firms making compensation changes within the eight-month window previous to the filing of the proxy statement prior to the 2011 annual meeting. The first two columns of Panel A present descriptive statistics of firms that filed 8-Ks announcing compensation changes that conform to ISS's policies. The second set of columns of Panel A present descriptive statistics of the remaining sample firms. The third set of columns of Panel A present descriptive statistics of firms that filed 8-Ks announcing compensation changes that are unrelated to ISS's policies. Compensation changes that conform with ISS policies are the following (see Appendix A): Amendment to outstanding awards, reduction of burn rate, new cash LTIP, reduction in cash comp, changes/amendments to change of control plans, new performance-based equity plan and reduction in benefits. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if: (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is below the median compensation of the peer companies (the peer group is defined following ISS's criteria). *ISS_influence* is calculated for each company as the average probability of each fund voting with ISS conditional on disagreement multiplied by the holdings of each fund in the company. *PctInstit* is the percentage of shares owned by institutions. Panel B presents similar statistics using a random sample of compensation-related 8-Ks filed within the eight-month window previous to the filing of the proxy statement corresponding to the 2006 - 2010 annual meetings. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. 2011 annual meeting (the initial SOP vote)

	Firms with PA aligned 8-Ks (1)		*Remainder of sample firms (2)*		*Firms with other compensation 8-Ks (3)*		*Diff. (1)-(2) p-values*		*Diff. (1)-(3) p-values*	
	Mean	Median	Mean	Median	Mean	Median	t-test	Wilcx	t-test	Wilcx
P4P	0.18	0.00	0.13	0.00	0.11	0.00	0.067	0.067	0.015	0.015
ISS_influence	9.34	8.74	8.77	8.27	9.09	8.76	0.090	0.043	0.496	0.442
PctInstit	0.77	0.81	0.71	0.77	0.72	0.77	0.000	0.001	0.004	0.033
Number of firms	275		1,733		377					
Number of changes	297				436					

Table 5. Characterization of compensation changes preceding the annual meeting (cont´d)

Panel B. 2006-2010 annual meetings (before the requirement of a SOP vote)

	Firms with PA aligned 8-Ks (1)		*Firms with other compensation 8-Ks (2)*		*Diff. (1)-(2) p-values*	
	Mean	Median	Mean	Median	t-test	Wilcx
P4P	0.07	0.00	0.06	0.00	0.539	0.539
ISS_influence	10.03	9.72	9.79	9.25	0.548	0.517
PctInstit	0.80	0.84	0.80	0.83	0.530	0.603
Number of firms	188		450			
Number of changes	201		532			

Table 6. Compensation changes and proxy advisors' SOP recommendations

This table presents results of probit regressions testing the association between ISS recommendations and changes in compensation previous to the proxy season. The dependent variable *ISS_against* equals one if ISS recommended a vote against the company's compensation practices and zero otherwise. The first set of columns includes all sample firms. The second set of columns includes 8-Ks filed during the 8 months previous to the proxy statement of the 2011 proxy season. *Sum_PA_Aligned* is the sum of *PA_Aligned* across all of the 8-Ks for each firm in the 8 months prior to the proxy statement of the 2011 proxy season. Proxy advisor aligned compensation changes are the following (see Appendix A): Amendment to outstanding awards, reduction of burn rate, new cash LTIP, reduction in cash comp, changes/amendments to change of control plans, new performance-based equity plan and reduction in benefits. *PA_Aligned* is the number of Proxy advisor aligned compensation changes announced in each 8-K. *P4P* is a pay-for-performance indicator variable that equals one (and zero otherwise) if: (i) the CEO's compensation increases from 2009 to 2010, (ii) total shareholders' returns in the last year (*TSR1Y*) is lower than the median *TSR1Y* among the companies in the same GICS code, (iii) total shareholders' returns in the last three years (*TSR3Y*) is lower than the median *TSR3Y* among the companies in the same GICS code, and (iv) the CEO's total compensation is below the median compensation of the peer companies (the peer group is defined following ISS's criteria). *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Dep. Var: ISS_against	*All sample firms*		*8-Ks with some type of compensation change*	
Indep. Variables:	coef	*t*-stat	coef	*t*-stat
Constant	1.38***	−30.56	−1.24***	−15.52
Sum_PA_Aligned	−0.16*	−1.73		
PA_Aligned			−0.22*	−1.94
P4P	1.31***	14.77	1.03***	7.07
Pseudo R^2		14.07%		8.73%
N		2,008		733

Table 7. Market reaction to compensation changes preceding SOP

This table analyzes cross-sectional differences in the market reaction to compensation-related 8-Ks filed during the eight months prior to the proxy statement release date. The dependent variable, *AdjRet*, is the average daily risk-adjusted return on the day of the 8-K filing, estimated using the Fama and French three-factor model plus momentum. *AdjRet* is expressed as a %. Column (1) includes 8-Ks filed during the 8 months preceding the proxy statement filing date in fiscal year 2011. Column (2) includes a random sample of 8-Ks from previous (2006-2010) fiscal years. *PA_Aligned* is the number of ISS-friendly compensation changes announced in the 8-K. ISS-friendly compensation changes are the following (see Appendix A): Amendment to outstanding awards, reduction of burn rate, new cash LTIP, reduction in cash comp, changes/amendments to change of control plans, new performance-based equity plan and reduction in benefits. Panel B compares *AdjRet* on the 8-K filing day to the average *AdjRet* on the 30 days preceding the 8-K filing date and the 30 days following the 8-k filing date. The *t*-stats are in parenthesis. *, **, and *** denote significance at the 10, 5 and 1% significance level (two-tail).

Panel A. Market reaction and comparison to previous proxy seasons

Dependent variable: AdjRet *Variable*	*2011 proxy season (1)*	*2006-2010 proxy seasons (2)*	*Difference in coefficients (1)-(2)*
Constant	0.096	0.162	−0.065
	(0.86)	(1.21)	(−0.89)
PA_Aligned	−0.444***	0.043	−0.488*
	(−2.91)	(0.21)	(−1.91)
N	733	733	
R^2	1.15%	0.01%	

Panel B. Comparison to market reaction on other days around the 8-K filing date

	AdjRet on days preceding the 8-k filing date (days −30 to −1) (1)	*AdjRet on 8-k filing date (day 0) (2)*	*AdjRet on days following the 8-k filing date (days 1 to 30) (3)*	*Difference in AdjRet (1)-(2)*	*Difference in AdjRet (2)-(3)*
8-Ks aligned with PA policies	0.011	−0.345***	0.019	0.356***	−0.365***
(N=297)	(0.41)	(−2.14)	(0.81)	(2.85)	(−3.19)
Other compensation 8-Ks	0.037	0.059	−0.001	−0.022	0.060
(N=436)	(1.51)	(0.58)	(−0.02)	(−0.19)	(0.60)

UNITED STATES HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

Hearing of the

Subcommittee on Capital Markets and Government Sponsored Enterprises

On
Examining the Market Power and Impact of Proxy Advisory Firms

June 5, 2013

Testimony of Lynn Turner

I would like to thank Chairman Garret and Ranking member Maloney, and members of the Committee for the opportunity to testify today.

I am Lynn Turner and I work as a managing director at the economic and forensic consulting firm LitiNomics. My comments draw upon my past experience as a member of the board of directors of public companies; as a member of the board of two institutional investors, one a mutual fund and the other a public pension fund; as a member of management and financial executive; as a former regulator with the Securities and Exchange Commission (SEC) where I served as Chief Accountant; as a member of management of a semiconductor company and also a senior executive and head of research of Glass Lewis during its initial four years.[1]

My experience has given me a broad and balanced perspective of proxy voting, and a well informed insight into the process. In the past, as a corporate board member, I have been the subject of proxy voting recommendations. As Vice President and head of research at Glass Lewis, I have participated in and overseen the process with respect to the preparation of proxy voting recommendations provided to investors and asset managers. And as a board member of two institutional investors which voted proxies, I have been involved with establishment of proxy voting guidelines and the proxy voting process.[2] Currently, I am a governor appointee to the board of the Public Employees Retirement Association of Colorado (Colorado PERA), a pension fund that manages the investments for hundreds of thousands of Coloradoans. I chair the shareholder responsibility committee of the fund which oversees the proxy voting by the fund. However, the comments I express today are my own views and not necessarily those of the PERA board, which takes formal positions only after public discussion and votes.

Proxy Voting

Proxy voting is an important right that the owners of public companies hold. These owners – investors – rely on the management teams to run the day to day operations of these companies and set their strategic and tactical plans. They also depend on members of the board of directors

[1] I have not had any financial or other interest in Glass Lewis since I left over 6 years ago.
[2] At the mutual fund, a "fund of funds complex, we utilized Institutional Shareholder Services for voting recommendations. At Colorado PERA the fund uses research principally from Glass Lewis but also uses Institutional Shareholder Services.

to exercise reasonable oversight of management including among many items, their performance and ability to achieve expected results, compensation, and business investment decisions.

Proxy voting provides investors, and/or the asset managers managing their money, with a useful market based mechanism with which to establish the accountability of both the board of directors and management. It permits investors as owners of the company, to weigh in on important matters and to express their approval, or disapproval, of the performance of those on the board who serve as their elected representatives, just as members of Congress served those who elect them.

My experience has demonstrated that many, but perhaps not all, investors take this responsibility very seriously. I believe that if you examine the web sites of the largest public pension funds you will find almost all have their own custom proxy voting guidelines. Similarly, if you look at the websites of the 15 largest money managers such as Fidelity, Vanguard, and Blackrock, you will find they also have their own custom designed proxy voting guidelines, as well as staff dedicated to proxy voting.

Upon reading the proxy voting guidelines of some of these asset managers, it appears that they have adopted policies that are similar to those of the two proxy advisory firms, Institutional Shareholder Services (ISS) or Glass Lewis (GL) on some issues. However, I believe this is most often the result of many in the investment community having similar views on what is "good governance." That is also why on proxy voting issues such as staggered boards, majority voting, pay for performance or poison pills, you will see investors at specific companies vote in agreement. In doing so, they may well vote in the same manner as ISS or GL have recommended. It is likely in such proxy contests, the asset managers would have voted similarly even if there had not been an ISS or GL recommendation.

My experience has informed me that the larger asset managers, such as Fidelity, Barclays or Black Rock, along with the large public pensions, are likely to follow their own voting guidelines and determinations, rather than those of ISS or GL. While they may buy research from the proxy voting services to gather useful information and assist with their analysis of the

issues, it is not uncommon they will vote differently than ISS or GL recommends, and often vote with management. And buying of such research, to add to one's available information about an issue, certainly should not be criticized in the context of trying to be fully informed about an issue. Interestingly, it is these large asset managers who also typically hold the largest percentage of institutional investment in public companies. I believe my experience is very consistent with useful data the Council of Institutional Investors (CII) has also provided the Subcommittee.

Proxy Voting in the Global Market Place

In today's global markets, an asset manager may invest in dozens of capital markets, and in thousands of public companies. For example, at Colorado PERA, the fund makes and manages investments on a global basis in 7,000 to 8,000 companies. The proxies for these companies may involve the election of numerous directors, approval of compensation and acquisitions, shareholder initiatives submitted for shareholder approval, and any number of additional matters. Proxies in non U.S. markets are often the subject of different proxy laws and requirements requiring knowledge of each jurisdiction, if one is to vote responsibly. Some foreign countries have a very short period of time between when shareholders are informed of the matters subject to shareholder vote, and when the proxy votes must be completed.

Many mutual or pension funds do not have unlimited staff who can read thousands of proxies and then research and submit an informed vote on the issues as required. My experience tells me that it would take well over a hundred staff, at a very significant cost to vote 8,000 proxies in a global market place. That would be a cost that would have to be passed on to investors, significantly increasing their fees, and reducing their investment returns, and ultimately, the amounts they are trying to save for retirement.

Instead, the funds rely, in part, on research they can buy from ISS and/or GL or others, along with their own research and proxy voting guidelines, to make a decision on how to vote. From one perspective, this is not that much different from a board of directors who must rely on

management and staff of a company to keep up to date and informed about the business and in their conduct of board votes.

Transparency in Proxy Voting

There is a significant amount of transparency today when it comes to proxy voting. For example, both ISS and GL post their proxy voting guidelines for all to see on their public web sites.[3] Most large pension and mutual funds also post their proxy voting guidelines.[4]

At Colorado PERA, the Shareholder Responsibility Committee reviews the proxy voting guidelines, in a public meeting, on an annual basis. The committee also reviews and analyzes the voting record of the fund on key and significant issues. Proxy votes that engender a lot of attention are also reviewed. At times, the PERA staff also contact me in advance of select votes to discuss those votes, which are subsequently also discussed in a public board meeting. At the mutual fund I served on the board of, we had a similar process with the exception that our board meetings were not public.

Much to their credit, ISS goes through a very robust public comment process each year in which their guidelines are posted for public comment. Comment letters received by ISS are also made public. ISS makes the updates and changes to their policies publicly available on their website as well. They also conduct significant outreach to various parties. I suspect that from beginning to end, their process is as transparent as, or more so than federal agencies may undertake with respect to rule making.

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[3] See GL proxy voting guidelines at: http://www.glasslewis.com/issuer/guidelines/
ISS proxy voting guidelines are also available at
http://www.issgovernance.com/policy/2013/policy_information

[4] See Colorado PERA Proxy Voting Policy at:
https://www.copera.org/board/shareholdercommittee/ProxyVotingPolicy.pdf

GL each year undertakes significant outreach to those investors who are their clients. They seek and receive from such clients their views on proxy voting issues. GL also interact with public companies receiving feedback.

However, it is important that the voters – investors who own the companies – determine their voting guidelines and how they will vote. It should not be up to non investors, to decide how the investors will vote on a particular issue. While it is more than fair to permit management to give their perspective on an issue, which they can do in the proxy statement they control, it would be highly improper for them to establish the rules with respect to how an investor will vote on a particular issue.

For example, I have heard some express a view that ISS or GL should have to submit drafts of their proxy voting recommendations to management before they can issue a final report. I find such a notion absurd, as in and of itself, it creates an inherent conflict with management permitted to edit a report on recommendations that affect them directly. It is akin to requiring teachers to submit report cards to students for editing before they can be sent home. While this is something we all might have liked at one point in time or another, I don't believe it is something that would improve the quality of grading.

However, as I discuss further below, I believe transparency in voting can and should be improved. Currently, mutual funds disclose once a year how they voted on proxies during the course of the year. By the time they disclose the vote, it is old news and history for the investors who have given them the money they manage. Investors deserve more timely information.

At Colorado PERA, we disclose our votes within 30 days. Other pension funds disclose their votes quicker. I believe more timely disclosure of votes by asset managers to investors should be required as I discuss below.

Does One Size Fit All?

An issue I hear from time to time is that the proxy voting guidelines of GL, ISS or for that matter, mutual or pension funds are akin to a "check the box" approach to corporate governance and too rigid. Companies argue they should be tailored to each company. Given there are 8,000 to 10,000 public companies in the United States alone, that would take a lot of "tailoring."

The practical reality today is that there is a fair degree of consensus around many, but not all, governance issues. For example, over the years, many of the large US public companies have agreed to accept a majority voting standard for directors. As a result, many proxy voting guidelines endorse such a governance measure. Likewise, many investors oppose the creation of poison pills or staggered boards that may hamper, rather than enhance shareholder value. As a result, these views, once viewed as "way out there" are now often contained in proxy voting guidelines. As a result, while such positions may be in the policy guidelines of ISS and GL, they are also likely to be in the custom guidelines of many other pension or mutual funds.

At the same time, pension and mutual funds do not view their proxy voting guidelines as rigid documents that must be followed on every vote. On occasion, at both the mutual and pension funds whose boards I have served on, I have received calls from our staff in which it was explained to me a waiver of our guidelines would be appropriate. The PERA guidelines in fact note that some issues will be voted on a case by case approach considering the fiduciary obligation the fund has to those whose money it manages. And while I was at GL, it was not uncommon at all that our clients would vote in a manner inconsistent with the GL guidelines. To say that GL dictates to their clients how they must vote couldn't be further from the truth, a stretch of one's imagination.

Myth Busters

There are a couple of "Myths" with respect to proxy voting I would like to address. The first one is that ISS, GL or the pension funds are somehow "biased" against management and vote according to how the labor organizations would like them to vote.

In my opinion, if there is a bias, it is towards management. For example, Colorado PERA voted on 37,365 management proposals in 2012. PERA voted with management or against the shareholder on 32,039 of those proposals or 85.75 percent of the time. On 1,545 shareholder governance proposals, PERA voted with management on 924 of the proposals or 59.81 percent of the time as opposed to just 40.19 percent of the time with shareholders. I believe the Council of Institutional Investors and the Florida State Board of Administration have also provided the Subcommittee with evidence of a bias towards voting with management on issues.

Another indication of this bias towards management is in voting recommendations by ISS. According to ISS, to date in 2013, ISS has recommended a vote for directors of Russell 3000 companies 92.8 percent of the time as opposed to a withhold or against recommendation just 7.2 percent of the time. During the 2012 calendar year, ISS recommended for 91.3 percent of the nominees at Russell 3000 companies as opposed to a vote against or for withhold just 8.7 percent of the time. Given half of the companies in the market are underperforming the market and half are outperforming, votes for over 90 percent of the directors can hardly be construed as a bias against management and the directors. It is also worth noting that even when directors fail to garner a majority of support from the shareholders, they seldom resign, choosing instead to ignore the vote.

With respect to GL voting, to date in 2013, they have recommended a "withhold" vote against 19,952 directors or just 9.95 percent of the time. In 2012, in the election of 26,366 directors, they recommended a withhold vote 12.85 percent of the time, a similar percentage to their vote in 2011. Of 65 directors who failed to gain 50 percent of the support from their investors in 2012, GL recommended for 8 of those directors. Of 2011 directors who failed to get a majority support in 2011, GL had recommended a vote for 22 of those directors. Once again, the facts do show a bias toward management and existing directors.

The reality is that there are around 100 or fewer proxy voting contests each year that garner the attention of the press and media. These typically are the result of a significant event at a company including poor stock performance, large amounts of compensation coupled with poor

company performance, a financial debacle of some sort, or a failure of the board and management to adequately explain actions they have taken such as with respect to acquisitions.

A recent example of this was the proxy contest at Hewlett Packard. This company had total shareholder returns of a negative 22.5 percent over the recent five year period. During this period the company's market capitalization (value) had dropped precipitously. Management had to write off as worthless over $19 billion they had paid out for acquisitions during that period. They had also gone through a number of CEOs and had experienced turmoil and turnover on the board. It is no wonder then that investors did express concern about the returns they were receiving on their investments, and the management and board of trustees who were stewarding the company. It was clearly not just labor funds who were involved with this contested proxy vote.

Another such example is the recent contested election of a director and chairman of the board at Occidental Petroleum Company (OXY). Oxy had a total shareholder return of just 1.89 percent over the previous five years. The company surprised the market by announcing they were seeking a new CEO, in a move viewed by some as driven by the former CEO who had become chairman of the board. The recently retired CEO had been one of the most highly compensated CEO's in America. This resulted in shareholders casting "... their shares against him by more than a 3-to-1 margin."[5] Clearly many investors were involved with this outcome, which was not driven by labor funds.

Another myth is that research reports from ISS and GL are inaccurate and contain many errors in data. Certainly, with up to 40,000 proxies being voted around the globe, and each of those proxies having a multiple of votes, some errors, while not desired, are inevitable given the process involves humans.

When errors do occur, there are mechanisms for addressing the issue. For example, on their website, GL has a web page for issuers. On this web page issuers can contact GL directly and

[5] Dailey Finance at: http://www.dailyfinance.com/2013/05/06/ray-irani-ousted-chairman-occidental-petroleum/

make them aware of any errors.[6] It has been my experience, that when proxy advisors are made aware of errors, they respond in a responsible fashion, correct their reports, and republish them with the corrected information.

However, when I was head of research at GL, it was not uncommon that I would take a call and have a discussion with a company official regarding the "facts" in a report. However, the facts at times turned out to be correct, and it was really the recommendation that the official had a problem with. At other times a fact was wrong and needed to be corrected because the disclosures in the proxy were not clear. Since proxy advisors do rely extensively on the public disclosures in proxy statements, the quality and accuracy of their research can be limited by the quality of the proxy disclosures.

My experience using both GL and ISS reports are that they are typically correct, and provide a reasonable basis for the recommendation provided.

Recommendations

As a former executive, I have found that one should always look for continuous improvement. I believe proxy voting is no different in that regards, and there are things that can be done to improve our proxy voting system. They include:

1. Improving transparency. I believe that proxy voting, and the votes actually made by asset managers should be transparent to the people whose money they manage on a timely basis, just as is done with political elections. Once a year, mutual funds do disclose their votes, often long after they have been cast and the elections are over. Instead, I believe asset managers should be required to disclose their votes to those who money they are managing at the time they actually vote.
2. Removing conflicts of interest. I strongly believe that one is very conflicted when they consult on how to establish or improve corporate governance or compensation plans, and then turn around and issue a recommendation on whether or not what the company has

[6] See GL website: http://www.glasslewis.com/issuer/

done is acceptable. This is all too similar to having an auditor do the book keeping for a public company, and then opine on whether the books are done right or not. Congress has banned such conflicts for auditors and I believe a similar ban should be enacted for proxy advisors. While disclosure of these conflicts would be helpful, it is, in and of itself, insufficient.

3. Regulation and Oversight. Proxy advisory services provide a useful source of data and information. It is important that information is credible, reliable, and timely. It must also be conflict free and done in a transparent fashion. As a result, I believe proxy advisory services should be subject to SEC oversight.[7] The SEC should establish a regulatory scheme that makes sense and can achieve the desired result. While some have called for all proxy advisory services to register as investment advisors, I am not sure that regime is designed to adequately (or smartly) address regulation of proxy advisors who typically do not give investment advice. Rather regulation of proxy advisors should ensure they:
    a. Fulfill a fiduciary obligation to recommend votes in a manner that is in the best interest of investors.
    b. Provide credible, accurate and timely research.
    c. Have a reasonable basis for recommendations they make.
    d. Remain free of conflicts.
    e. Have adequate training and compliance programs.
    f. Ensure that confidential data is securely maintained.
4. Fiduciary Obligation. There has been discussion surrounding SEC regulations adopted in the last decade, and whether or not an asset manager can meet its fiduciary obligation by "outsourcing or farming out" the voting decisions to a proxy advisory firm. While I believe the proxy advisory firms do provide invaluable research into voting decisions that are made, and accordingly, are important to fulfilling a fiduciary obligation, I do not believe the research report of a proxy advisory firm can or should replace the fiduciary obligation of an asset manager to those whose money it is managing. Accordingly, I believe the SEC and Department of Labor should clarify who has the principal fiduciary obligation when it comes to proxy voting; that the fiduciary obligation cannot be

outsourced; and that all proxy votes must be done in a manner that is *solely in the best interest of the investors in a fund*. In addition, it should be clarified that if a board of trustees of a mutual fund "outsource" the proxy voting to an affiliate of the mutual fund complex, that affiliate has a direct fiduciary obligation to the investors as well.

5. Voting Standard. Today many of the largest companies in America have adopted a majority voting standard for election of directors. Yet in some limited instances directors have failed to receive the support of a majority of investors they represent. All too often such directors have remained on the boards, despite the lack of support for them from the owners of the business. As a result, I strongly believe a majority voting standard for directors should be enacted, and directors who fail to win the support of a majority of voting investors should not be allowed to continue to represent the investors.

Thank you Mr. Chairman. I would be happy to respond to any questions you or members of the Subcommittee might have.

[7] ISS is registered as an investment advisor. GL was initially registered as an investment advisor when it was created. However, upon advice from counsel, including a former SEC director of the Investment Management Division, GL deregistered and continues to be deregistered today.

Statement of

Gary Retelny, President

Institutional Shareholder Services Inc.

to the

Subcommittee on Capital Markets and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

June 5, 2013

Examining the Market Power and Impact of Proxy Advisory Firms

To: The Honorable Scott Garrett
Chairman
Subcommittee on Capital Markets and Government Sponsored Enterprises

Institutional Shareholder Services Inc. ("ISS" or the "Company") respectfully requests that the following statement be included in the record for the June 5, 2013 hearing convened by the Subcommittee on Capital Markets and Government Sponsored Enterprises on Examining the Market Power and Impact of Proxy Advisory Firms (the "Hearing").

Introduction

ISS is a full-service proxy adviser with more than 25 years of experience helping institutional investors make informed proxy voting decisions, manage the complex process of voting their shares and report their votes to their stakeholders and regulators. ISS annually covers more than 40,000 shareholder meetings -- every holding in ISS' clients' portfolios -- in over 100 developed and emerging markets worldwide. All proxy analysis at ISS is undertaken in accordance with a published analytical framework comprised of voting policy guidelines chosen by ISS' clients. ISS offers a wide range of proxy voting policy options, including both standard benchmark policies focused solely on maximizing shareholder value, and specialty policies that

evaluate governance issues from the perspective of sustainability, socially-responsible investing, public funds, labor unions or mission and faith-based investing. ISS' voting policies and recommendations are the antithesis of one-size-fits-all. Case-by-case analytical frameworks, which take into account company size, financial performance and industry practices, drive the vast majority of ISS' vote recommendations.

ISS also makes and implements proxy voting recommendations based on a client's specific customized voting guidelines, and may assist clients in developing such custom guidelines as well. In fact, more than one-third of ISS' institutional investor clients turn to us for research and vote recommendations that reflect their unique corporate governance philosophies or those of their underlying clients. Overall, ISS implements more than 400 custom voting policies on behalf of institutional investor clients.

Except in extremely rare situations where a client has a conflict of interest and asks ISS to make a proxy voting decision on the client's behalf, ISS clients control both their voting policies and final vote decisions. They may, however, outsource the ballot processing and data management elements of their proxy voting operations to ISS. To this end, ISS often receives clients' ballots, co-ordinates with their custodian banks, executes votes based on client instructions, maintains voting records and provides reporting. By outsourcing these arduous administrative tasks, ISS' clients are able to devote more of their internal resources to making informed voting decisions.

The Market Impact of Proxy Advisers

ISS' clients use our proxy research and vote recommendations in a variety of ways. ISS' research and vote recommendations are just one source of information that clients use in arriving at their independent voting decisions. Many investors, for example, have internal research teams that conduct proprietary research and use ISS research to supplement their

own work. Some clients use ISS research as a screening tool to identify non-routine meetings or proposals. A number of our clients use the services of two or more proxy advisory services.

It is unclear to what extent investors vote consistently with the recommendations of proxy advisory firms, particularly since investors use vote recommendations differently and such use is not easily monitored or quantified. Unfortunately, such complexity does not stop some commentators from asserting that a fairly large percentage of votes are "controlled by ISS." These misleading assertions have taken on a life of their own as they are repeated by other commentators who cite the initial statement as fact.

There is, however, independent empirical evidence to the contrary. University of Pennsylvania Law School Professor Jill Fisch, along with academic colleagues from New York University, have addressed this issue through quantitative analysis. In their paper, *The Power of Proxy Advisors: Myth or Reality?,*[1] the team analyzed the effect of proxy adviser recommendations on voting outcomes in uncontested director elections and concluded that media reports substantially overstate the extent of ISS' influence by failing to control for the underlying company-specific factors that influence voting outcomes. Controlling for these factors, Professor Fisch and her colleagues estimate that an ISS recommendation shifts 6 to 10 percent of shareholder votes:

> Although superficial analyses suggest that an ISS recommendation can have a marginal impact of as much as 20%, and press reports state that ISS has the power to shift 20% to 30% of the shareholder vote, we conclude that these numbers are substantially overstated. In particular, our findings reveal that although an ISS recommendation has independent value, this value is greatly reduced once we take into account the company- and firm-specific factors that are important to investors. Depending on the test, we find that the impact of an ISS recommendation ranges from 6% to 13% for the median company. Overall, we consider it likely that an ISS recommendation shifts 6% to

[1] Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, The Power of Proxy Advisors: Myth or Reality?. Emory Law Journal, Vol. 59, p. 869, 2010; University of Penn, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: http://ssrn.com/abstract=1694535.

> 10% of shareholder votes—a material percentage but far less than commonly attributed to ISS.[2]

The authors suggest that a major component of this influence may stem from ISS' role as information agent:

> Furthermore, we find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms. Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences.[3]

This assessment is consistent with ISS' experience of how our clients actually use our proxy research and vote recommendations. It is also in line with a recent survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers:

> Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors.[4]

Proxy Advisers and the Investment Adviser Regulatory Regime

ISS has been registered with the SEC as an investment adviser since 1997. While some suggest that the investment adviser regulatory regime is ill-suited to proxy advisers, that view

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[2] *Id.* at 905-06.

[3] *Id.* at 906.

[4] Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: http://ssrn.com/abstract=2084231. "Between November 2011 and March 2012, on behalf of the IRRC Institute, Tapestry Networks undertook an extensive inquiry into US asset managers' voting decision processes, as well as their views on the role proxy advisory firms play in those processes. In addition to reviewing major academic studies and current literature on the topic, [Tapestry] interviewed senior executives from 19 leading North American asset management firms and their affiliates, as well as academics, proxy advisory firms, proxy solicitors, and other stakeholders. In total, the investors [Tapestry] interviewed account for over $15.4 trillion in assets under management, or more than half of the assets under management in the United States." *Id.* at 1.

misapprehends the nature of such regulation. The Investment Advisers Act of 1940 ("Advisers Act") defines an investment adviser as a person who, for compensation and as part of a regular business, advises others about the value of securities or whether to buy or sell securities, or who issues reports or analyses about securities.[5] Contrary to popular belief, the term is not synonymous with asset manager. In its 2010 Concept Release on the U.S. Proxy System, the SEC explained the applicability of the Advisers Act to proxy advisers as follows:

> [P]roxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote at shareholder meetings. . . . We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to maximize the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.[6]

While some aspects of the investment adviser regulatory regime are directed exclusively at asset managers, many of the regime's core requirements apply with equal force to managers and research-oriented firms like proxy advisers. In this regard, the Advisers Act and related rules oblige proxy advisers to:

- implement a Code of Ethics;
- designate a Chief Compliance Officer;
- adopt a comprehensive set of compliance procedures -- including procedures relating to proxy voting -- reasonably designed to prevent, detect and correct violations of the Advisers Act;
- at least annually assess the sufficiency of the compliance procedures and the effectiveness of their implementation;
- maintain a comprehensive set of books and records;
- make full disclosure to clients and prospective clients about the adviser's business and any potential conflicts of interest related thereto.

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[5] Advisers Act Section 202(a)(11) [15 USC 80b-2(a)(11)].

[6] Concept Release on the U.S. Proxy System, SEC Rel. No. IA-3052 (July 14, 2010) at 109-110, 75 Fed Reg. 42981, 43010 (July 22, 2010).

Underlying all these obligations is the fundamental principle that an investment adviser is a fiduciary. In the SEC's words:

> The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers. The Court stated that '[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate or at least to expose, all conflicts of interest which might incline an investment adviser -- consciously or unconsciously -- to render advice which was not disinterested.' As investment advisers, proxy advisory firms owe fiduciary duties to their advisory clients. (internal citations omitted).[7]

In view of the Hearing's focus on conflicts of interest in the proxy adviser industry, the question that begs to be asked is not why ISS is registered as an investment adviser, but why certain of its competitors are not. In order to enhance investor protection, ISS submits that all institutional proxy advisers should be subject to the extensive conflict management and disclosure requirements that exist today under the Advisers Act. There is no need for a new regulatory regime in this area.

The Advisers Act Proxy Rule and the Use of Third-Party Proxy Advisers

In January 2003, under the leadership of then-Chairman Harvey Pitt, the SEC adopted Advisers Act Rule 206(4)-6 to address an adviser's fiduciary obligations when the adviser is authorized to vote client proxies.[8] In this regard, the rule requires advisers to adopt proxy voting policies and procedures, describe those policies and procedures to clients and tell clients how to obtain information about how their votes were cast.

The policies and procedures required under the rule must be reasonably designed to ensure that when an adviser votes a client's proxies, it does so in the client's best interests. This

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[7] *Id.* at 110, 75 Fed. Reg. at 43010, *quoting SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

[8] Proxy Voting by Investment Advisers, SEC Release No. IA-2106 (Jan. 31, 2003), 68 Fed. Reg. 6585 (Feb. 7, 2003) ("Proxy Rule Release"). At the same time it addressed proxy voting under the Advisers Act, the Commission adopted parallel requirements for mutual funds under the Investment Company Act of 1940. Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release No. IC-25922 (January 31, 2003), 68 Fed. Reg. 6564 (Feb. 7, 2003).

means, among other things, the policies and procedures must describe how the adviser addresses any material conflicts between its interests and those of its clients with respect to proxy voting.[9] Because different advisers face different types of conflicts, the SEC rejected a one-size-fits-all approach to crafting policies and procedures. However, in adopting Rule 206(4)-6, the Commission noted a variety of ways in which conflicts could be addressed, including through the use of third-party advisers. In the Commission's words:

> [A]n adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party.[10]

The following year, the staff of the SEC's Division of Investment Management issued a no-action letter to ISS addressing the manner in which a registered investment adviser could -- consistent with its fiduciary duties to its clients -- determine the independence of a third-party proxy advisory service.[11] In this regard, the staff explained:

> Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process. . . . An investment adviser should have a thorough understanding of the proxy voting firm's business and the nature of the conflicts of interest that the business presents, and should assess whether the firm's conflict procedures negate the conflicts.[12]

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[9] Material conflicts could arise where the adviser has a business or personal relationship with a company whose management is soliciting proxies, with participants in a proxy contest, or with candidates for corporate directorships.

[10] Proxy Rule Release at 5, 68 Fed. Reg. at 6588.

[11] Institutional Shareholder Services Inc., 2004 SEC No-Act. LEXIS 736 (September 15, 2004); *see also* Egan-Jones Proxy Services, 2004 SEC No-Act. LEXIS 636 (May 27, 2004). Contrary to Chairman Pitt's surprising assertion at the Hearing, the Staff's letter to ISS was neither unauthorized nor unusual, but rather was appropriate interpretive guidance regarding a fiduciary standard the Commission itself had articulated.

[12] Institutional Shareholder Services, Inc., 2004 SEC No-Act. LEXIS 736 at *4-5

The staff went on to state that because a proxy advisory firm's business and/or conflict procedures could change over time, the investment adviser has a fiduciary duty to monitor a third-party service provider's independence on an ongoing basis. Thus, contrary to assertions made at the Hearing, the staff did not authorize advisers to outsource their fiduciary duties relating to proxy voting. Instead, the staff explained the steps advisers should take to satisfy those duties when using third-party proxy advisory services.

ISS' Approach to Managing Conflicts of Interest

ISS' institutional investor clients have taken the SEC and its staff's guidance on fiduciary obligations in proxy voting to heart. Both before engaging ISS to render vote recommendations[13] and periodically thereafter, these clients undertake a thorough examination of the ways in which ISS manages potential conflicts of interest.

ISS mitigates conflicts, first and foremost, by being a transparent, policy-based organization. Its use of a series of published voting policies provides a very practical check and balance that ensures the integrity and independence of ISS' analyses and vote recommendations. While these policies allow analysts to consider company- and market-specific factors in generating vote recommendations, the existence of a published analytical framework, coupled with the fact that vote recommendations are based on publicly-available information, allows ISS clients to continuously monitor the integrity of ISS advice.[14]

Furthermore, pursuant to its own obligations under the investment adviser regulatory regime, ISS has undertaken a comprehensive risk assessment to identify specific conflicts of interest related to its operations and has adopted compliance controls reasonably designed to manage those risks. One of the primary components of its compliance program is a Code of Ethics that prescribes standards of conduct for ISS and its employees.

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[13] As explained above, clients rarely delegate decision-making authority over proxy votes to ISS.

[14] Each ISS analysis includes a URL for a direct hyperlink to ISS' summary voting guidelines for easy access by users of our research.

The Code of Ethics affirms ISS' fiduciary relationship with its clients and obligates ISS and its employees to carry out their duties solely in the best interests of clients and free from any compromising influences and loyalties. The Code also contains restrictions on personal trading designed to prevent employees from improperly trading on, or benefiting from, inside information, client information and/or ISS' voting recommendations. The Code emphasizes the requirement that all research for clients be rendered independently of employees' personal interests.

In order to ensure compliance with the Code of Ethics, ISS conducts periodic training sessions for employees and requires employees to affirm their commitment to compliance on an annual basis. Furthermore, ISS regularly monitors the sufficiency of the Code and the effectiveness of its implementation.

- **Conflicts in Connection with Affiliated Corporate Services**

Another critical component of the ISS compliance program is the firewall it maintains between its institutional business and the corporate services offered by its subsidiary, ISS Corporate Services, Inc. ("ICS"). This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning the identity of ICS' clients, thereby ensuring the objectivity and independence of ISS' research process and vote recommendations. The firewall mitigates potential conflicts via several layers of separation:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- ISS Global Research team works independently from ICS.
- ICS and ISS staff are prohibited from discussing the identity of ICS clients.
- Institutional analysts' salaries, bonuses and other forms of compensation are not

linked to any specific ICS activity or sale.

- ICS explicitly tells its corporate clients that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. ICS further informs its clients that ISS' Global Research team prepares its analyses and vote recommendations independently of, and with no involvement from, ICS.
- ISS clients can request a list of all ICS clients.

As is the case with the Code of Ethics, ISS maintains a robust training and monitoring program regarding the firewall. This program includes quarterly tests of the firewall's integrity, new-hire orientation, and review of certain marketing materials and disclosures. There also is an ethics hotline available to both ICS and ISS staff for reporting issues of potential concern.

- **Conflicts in Connection with ISS' Parent Company**

In addition to managing conflicts arising from the corporate advisory services of its ICS affiliate, steps have been taken to protect ISS' independence from its ultimate parent corporation, MSCI Inc. First, ISS recuses itself from making voting recommendations regarding MSCI proxy issues, and instead supplies clients with the analyses of multiple other proxy advisory firms to inform their vote decision. Furthermore, the MSCI Board of Directors has adopted resolutions stating that: (i) the formulation, development and application of ISS' proxy voting policies (including the establishment of voting standards), proxy analyses and vote recommendations are and shall remain the sole responsibility of ISS at all times; (ii) the non-executive members of the MSCI Board of Directors shall have no role in formulating, developing or implementing ISS' proxy voting policies, proxy analyses and/or vote recommendations; and (iii) the non-executive members of the MSCI Board of Directors shall not be informed of the content of any ISS proxy analyses or vote recommendations prior to their publication or dissemination.

The MSCI Inc. Board of Directors also has adopted a Conflicts of Interest Policy related to "Director Affiliated Companies" to address any potential conflicts of interest posed by other public company board seats held by any MSCI Inc. director.

- **Conflicts Within the Institutional Advisory Business**

Conflicts theoretically may also arise where an ISS client (or a client of MSCI) is also a public company whose own proxies are the subject of analyses and voting recommendations, or other advisory research report, or where the Company is called upon to analyze and vote on shareholder proposals propounded by a Company client. In order to manage conflicts in this area, the Company appends a conflict legend to each research report indicating that the issuer whose proxy is being analyzed may be a client of, or affiliated with a client of MSCI or its subsidiaries including, ISS or ICS. ISS is careful not to provide preferential treatment to shareholder proponents that are ISS proxy clients.

- **Conflicts in Connection with Issuers' Review of Draft Analyses**

If, upon reviewing a draft proxy vote analysis, an issuer notifies ISS in writing of one or more factual inaccuracies in the draft, an ISS analyst may decide to change his or her proposed voting recommendation. In order to ensure the propriety of the interaction between the issuer and the analyst, the analyst's decision to change the vote recommendation must be reviewed by a senior analyst and appropriate records must be kept of the communication from the issuer and the voting decision. These records are subject to the Chief Compliance Officer's periodic review.

- **Disclosure Regarding Potential Conflicts**

ISS provides its investor clients with an extensive array of information to ensure that they are fully informed of potential conflicts and the steps ISS has taken to address them. In addition to making full disclosure in the Form ADV brochure it delivers to each client, ISS supplies a comprehensive due diligence compliance package on its web site to assist clients and prospective clients in fulfilling their own obligations regarding the use of independent, third-party proxy voting firms. This package includes a copy of ISS' Code of Ethics, a description of other policies, procedures and practices regarding potential conflicts of interest and a description of the ICS

business. A copy of the MSCI Board of Directors Conflicts of Interest Policy related to Director-Affiliated Companies is also available through the ISS web site.

Moreover, each proxy analysis and research report ISS issues contains a legend indicating that the subject of the analysis or report may be a client of or affiliated with a client of ISS, ICS or another MSCI subsidiary. Each analysis and report also notes that one or more proponents of a shareholder proposal may be a client of ISS or one of its affiliates, or may be affiliated with such a party. Clients who wish to learn more about the relationship, if any, between ICS and the subject of an analysis or report are invited to contact ISS' Legal and Compliance Department for relevant details. This process allows ISS' proxy voting clients to receive the names of ICS clients without revealing that information to research analysts as they prepare vote recommendations and other research. Were the ICS relationship identified on the face of a proxy analysis or report, this critical information barrier would be destroyed.

ISS believes that these extensive measures provide clients with a high degree of comfort that ISS has eliminated or is effectively managing the potential conflicts of interest its business entails.

ISS' Commitment to Transparency

In addition to transparency regarding its conflicts management policies, ISS also is committed to transparency in the formulation of its proxy voting policies and guidelines, collecting information from a diverse range of market participants through multiple channels.[15]

Each year, this policy-setting process begins with a Policy Survey seeking input from both institutional investors and corporate issuers in an effort to identify emerging issues that

[15] For example, the 2013 comment period drew responses from investors (such as CalSTRS and T. Rowe Price), individual issuers (such as Comcast, eBay, Exxon Mobil and FedEx) and trade groups (such as the Business Roundtable, the Center on Executive Compensation, the National Association of Corporate Directors, the Society of Corporate Secretaries and Governance Professionals and the U.S. Chamber of Commerce).

merit attention prior to the upcoming proxy season. Based on this feedback, ISS convenes a series of roundtables with various industry groups and outside issue experts to gather multiple perspectives on complex or contentious issues. As part of this process, ISS researchers examine academic literature, other empirical research and relevant commentary in an effort to uncover potential links between an issue and financial returns and/or risk.

The ISS Global Policy Board, which is comprised of ISS' market research heads and subject matter experts, uses this input to develop its draft policy updates. Before finalizing these updates, ISS publishes them for an open review and comment period (modeled on the SEC's process for commenting on pending rule-making). This open comment period is designed to elicit objective, specific feedback from investors, corporate issuers and industry constituents on the practical implementation of proposed policies. For the past several years, all comments received by ISS have been posted verbatim to the ISS Policy Gateway on its public website, in order to provide additional transparency into the feedback we have received. Final updates are published in November, to apply to meetings held after February of the following year.

To our knowledge, ISS is the only proxy adviser to gather, assess and incorporate market feedback into its institutional proxy voting policies and remains committed to a robust and transparent policy formulation process.

- **Engagement Yields Better Research**

ISS' outreach is not confined to its policy-setting process. Robust engagement is an essential part of ISS' day-to-day operations. Each season, ISS engages with thousands of corporate executives, board members, institutional investors and other constituents via in-person meetings, conference calls and participation in industry events.

As a research organization, ISS encourages constructive dialogue on critical issues to ensure a deeper understanding of the company-specific facts and circumstances, which in turn informs its proxy analyses and recommendations. As part of the year-round research process, ISS analysts have regular interactions with company representatives, institutional shareholders, shareholder proponents and other parties to gain insight into key issues. The issues discussed can range from general policy perspectives to specific ballot items.

The purpose of such engagement is for ISS to obtain, or communicate clarification about governance and voting issues, in order to ensure that our research and policy-driven recommendations are based on the most comprehensive and accurate information available. Sometimes these conversations are initiated by ISS, and sometimes they are initiated by the issuer or shareholder. In contested situations, ISS ordinarily engages with both sides.

Insights gleaned from these engagements are reflected in ISS' proxy advisory reports when the information is deemed to be useful in helping its institutional clients make a more informed voting decision. In those instances, ISS may consider including direct quotes from statements made by participants in the meeting(s). At the discretion of the analyst, a brief "engagement summary" may be included on the front page of the analysis report.

In March 2012, ISS set a new high water mark for transparency and responsiveness by establishing a Feedback Review Board ("FRB"), chaired by ISS' President. The FRB provides an additional conduit for investors, executives, directors and other market constituents to communicate with ISS.

ISS' Commitment to Accuracy and Completeness

ISS goes to great lengths to ensure that its reports are complete and materially accurate. ISS has a myriad of policies and procedures to ensure the integrity of its research process. As explained above, ISS' analyses and recommendations are driven by publicly

disclosed and detailed policy guidelines in order to ensure consistency and to eliminate potential analyst implementation bias.

Furthermore, prior to delivery to clients, each proxy analysis undergoes a rigorous internal review for accuracy and to ensure that the relevant voting policy has been applied. In the U.S., companies found in the Standard & Poor's 500 index generally receive an opportunity to review a draft analysis for factual accuracy prior to delivery of the analysis. ISS reviews other requests for review and comment on a case-by-case basis. All issuers may request and receive a free copy of the published copy of its ISS analysis of its shareholder meeting.

ISS also conducts periodic SAS-70/SSAE 16 audits to ensure compliance with its internal control processes. ISS' research process is included in these audits. ISS believes that these controls reduce the chance that an analysis will be published with material errors and provide a correction mechanism after a report has been delivered.

While ISS strives to be as accurate as possible, the research team does, infrequently, identify material factual errors in our reports, such as those relating to the agenda, data or research/policy application. When this happens, the research team promptly issues a "Proxy Alert" ("Alert") to inform clients of any corrections and, if necessary, vote recommendation changes. Alerts are distributed to ISS' institutional clients through the same ProxyExchange platform used to distribute our regular proxy analyses.[16] This ensures that the clients who received an original analysis will also receive the related Alert, which is attached to the company meeting. During the 2012 calendar year, ISS delivered Alerts for 537 (1.5 percent) of 35,526 meetings covered around the globe. For the U.S. market, the 2012 correction rate was 2.3 percent (152 of 6,532 meetings).

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[16] An Alert is structured as an overlay on top of the original analysis; the first few pages show the corrected information and any related vote recommendation change(s), but the original analysis lies underneath, and continues to reflect the original information.

ISS acknowledges that corporate issuers do not always agree with our vote recommendations. This is understandable given that these recommendations are not always aligned with those of the company's management and board. Simply put, the interests of the company's owners can and do conflict with those of management and the board from time to time. ISS would not be serving its investor clients if it did not highlight these cases. ISS notes, however, that when issuers dispute our analyses, the disputes generally relate to policy application (or the principles underlying the policies themselves), not the factual accuracy of the analysis. ISS remains committed to working with governance stakeholders to ensure that policies reflect the input of all parties.

Conclusion

As the foregoing discussion demonstrates, proxy advisers play a valuable role in the U.S. capital markets by helping institutional investors make informed decisions on how to vote their proxies. While proxy advisers often assist institutional investors in fulfilling their fiduciary duties of care and loyalty, such investors do not and cannot "outsource" those duties to the proxy advisers. As the empirical evidence shows, proxy advisers do not control the outcome of proxy voting in the United States.

For their part, the proxy advisers are also fiduciaries, and are appropriately governed by the regulatory regime established under the Investment Advisers Act of 1940. That statute and the implementing rules adopted by the SEC oblige proxy advisers to assess, manage and disclose their conflicts of interest. ISS has done this by adopting a Code of Ethics and establishing a comprehensive set of conflict management procedures which it fully explains to clients and potential clients.

ISS' commitment to transparency is reflected as well in the way in which it formulates its proxy voting policies and guidelines. By engaging with investors, issuers, and other market

participants, ISS is able to enhance the quality of its research, analysis, and vote recommendations, all with the goal of enabling its clients to make well-informed proxy voting decisions.

* * * *

ISS commends the Subcommittee for examining the role of proxy advisers in helping shareholders fulfill their important role in corporate governance. ISS also appreciates the opportunity to submit this statement and would be delighted to provide the Subcommittee with any additional information it desires regarding these critical issues.

MUTUAL FUND DIRECTORS FORUM

The FORUM *for* FUND INDEPENDENT DIRECTORS

June 4, 2013

The Honorable Scott Garrett
Chairman
House Subcommittee on Capital Markets and
Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairman Garrett:

As the Subcommittee considers the role of proxy advisory firms, the Mutual Fund Directors Forum (MFDF) would like to provide you with a copy of a white paper we published entitled "Practical Guidance for Fund Directors on Oversight of Proxy Voting." This report discusses key decision points that mutual fund directors often consider when establishing proxy voting procedures and provides a summary of common proxy voting processes used throughout the mutual fund industry.

We ask that our letter be included with the record of the hearing on June 5 entitled "Examining the Market Power and Impact of Proxy Advisory Firms." The report can be found on our website at http://www.mfdf.org/images/uploads/newsroom/Oversight_of_Proxy_Voting.pdf.

Sincerely,

Susan Ferris Wyderko
President, CEO

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www.mfdf.com

Testimony of Sean Egan,
Chief Executive Officer, Egan-Jones Rating Company

To the Subcommittee on Capital Markets and
Government Sponsored Enterprises

"Examining the Market Power & Impact of Proxy Advisory Firms"

June 5, 2013

Chairman Garrett, Vice Chairman Hurt, Ranking Member Maloney and members of the subcommittee:

Proxy advisers are critical to the proper functioning of modern capital markets. Institutional investors of all sorts rely on proxy advisers to present a fair, balanced view so that those investors can properly fulfill their fiduciary obligations. By acting as agents for institutional investors, proxy advisers collect, analyze, and make recommendations to institutional investors on the various agenda items in proxy statements with the aim of protecting shareholders. Unfortunately, the process has been skewed such that investor protection has been all too often forgotten.

The first and only obligation of a proxy advisory service is to assist clients in enhancing and protecting shareholder value. Unfortunately some proxy advisers appear to have substituted social, public policy, and even political objectives ahead of fiduciary obligations to institutional investors. The recent annual JPMorgan proxy vote underscored a significant disconnect between the positions taken by proxy advisers ISS and Glass Lewis and the views of the majority of the investment market. Like most holders of JP Morgan shares, Egan-Jones Proxy Services recommended that Jamie Dimon be retained and that the role of the CEO and Chairman not be separated. We were in concert not only with the bulk of the investment community but also with nearly every prominent CEO who spoke out on the subject including Warren Buffett, Dave Cote of Honeywell, and John Mack of Morgan Stanley, and Dick Kovacevich of Wells Fargo.

Egan-Jones is focused on enhancing and protecting shareholders value. We let nothing - especially ideology - interfere with our obligation to clients. We believe institutional investors and other fiduciaries are best served by utilizing a proxy adviser whose views are aligned with theirs and who is focused on investor protection.

61 Station Road, Haverford, Pennsylvania, USA 19041

Statement of

Ann Yerger

Executive Director

Council of Institutional Investors

to the

Subcommittee on Capital Markets and Government Sponsored Enterprises

of the

Committee on Financial Services

United States House of Representatives

June 5, 2013

Examining the Market Power and Impact of Proxy Advisory Firms

Dear Mr. Chairman and Ranking Member Maloney:

The Council of Institutional Investors ("CII") respectfully requests that the following statement be included in the record for the June 5, 2013 hearing convened by the Subcommittee on Capital Markets and Government Sponsored Enterprises on Examining the Market Power and Impact of Proxy Advisory Firms. CII notes that the two largest U.S. proxy advisory firms, Glass Lewis & Co. ("Glass Lewis") and Institutional Shareholder Services ("ISS") are non-voting members of CII, paying an aggregate of $24,000 in annual dues—less than 1.0 percent of CII's membership revenues. In addition, CII is a client of ISS, paying approximately $19,600 annually to ISS for its proxy research.

CII

Founded in 1985, CII is a nonpartisan, not-for-profit association of public, labor and corporate employee benefit funds with assets collectively exceeding $3 trillion. CII is a leading advocate for improving corporate governance standards for U.S. public companies and strengthening investor rights.

CII members are diverse. Voting members include funds such as the New Jersey Division of Investment, the New York State Common Retirement Fund, Johnson & Johnson, and the IUE-CWA Pension Fund. Non-voting members include asset managers such as BlackRock, TIAA-CREF, State Street Global Advisors, and Capital Group Companies.[1]

CII members are responsible for investing and safeguarding assets used to fund retirement benefits for millions of participants and beneficiaries throughout the U.S. They have a

[1] See Attachment for a complete list of the Council's current members. For more information about the Council, please visit http://www.cii.org/members.

significant commitment to the U.S. capital markets, with the average CII member investing nearly 60 percent of its entire portfolio in U.S. stocks and bonds.[2]

They are also long-term, patient investors due to their far investment horizons and their heavy commitment to passive investment strategies. Because these passive strategies restrict Council members from exercising the "Wall Street walk" and selling their shares when they are dissatisfied, corporate governance issues are of great interest to our members.

One way CII members are engaged in corporate governance issues is through proxy voting. Owning stock in a company gives CII members and other investors the right to vote on important matters concerning corporate strategic decisions, such as significant mergers or acquisitions, and governance issues, such as the election of directors.

Because of the significance of the issues addressed on corporate ballots, the proxy vote is considered part of the underlying value of a stock. For CII members and others with fiduciary duties, proxy voting is also an obligation.

CII's corporate and labor fund members are subject to the 1974 Employee Retirement Income Security Act ("ERISA"), which requires fund fiduciaries to act solely in the best interests of plan participants and beneficiaries. While CII's public pension plans are not subject to ERISA, many state and local legislatures have adopted standards closely modeled on ERISA rules. And CII member funds sponsored by private trusts and tax-exempt institutions (such as universities and churches) also tend to follow ERISA fiduciary standards.

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[2] Council of Institutional Investors, *Asset Allocation Survey 2009*, 4 (on file with CII) ("Domestic stocks and bonds accounted for 57.5 percent of the average portfolio of surveyed Council members.").

As fiduciaries, CII members have a variety of specific duties regarding proxy voting, including:

- Fiduciaries must not vote based on their private interests, but rather to maximize the economic value of plan holdings;
- Votes must be cast on each issue that has an impact on the economic value of stock;
- Voting decisions should be based on a careful analysis of the vote's impact on the economic value of the investment; and
- If proxy voting is delegated, plan fiduciaries have duty to monitor proxy voting procedures and votes.

Proxy Advisory Firms

Proxy advisory firms have been in business for decades. Today, two firms—Glass Lewis and ISS—dominate the business, and several other smaller firms provide proxy advice and voting services. Most CII voting and non-voting members are clients of one or more of those firms.

CII believes that the influence of the proxy advisory firms has significantly declined in recent years, as asset managers, pension funds and others have taken greater interest in proxy voting and have developed in house expertise to address proxy-related issues. And others share CII's view. The Wall Street Journal's recent article entitled "For Proxy Advisers, Influence Wanes," noted:

> The landscape for proxy advisers is getting rockier.
>
> Big firms that sell recommendations on how to vote in corporate elections are losing some of their relevance, as companies more aggressively court key investors ahead of big votes and those investors handle more of the voting analysis themselves.[3]

[3] Joann Lubin & Kristen Grind, *For Proxy Advisers, Influence Wanes,* Wall St. J., May 22, 2013, http://online.wsj.com/article/SB10001424127887323336104578499554143793198.html.

Possible Steps Forward

CII believes that proxy advisory firms should:

- Register as investment advisers under the Investment Advisers Act of 1940;
- Provide substantive rationales for vote recommendations;
- Minimize conflicts of interest and disclose details of potential conflicts, including those involving companies or resolution sponsors, in the applicable meeting report;
- Correct material errors promptly and notify affected clients as soon as practicable; and
- Provide transparency into the general methodologies—without compromising proprietary models—used to make recommendations.

In addition, CII believes interpretive guidance and/or additional empirical data from the Staff of the U.S. Securities and Exchange Commission ("SEC" or "Commission") would be helpful in the following two areas: Specifically:

1. *We do not believe that the SEC's rules, or interpretations thereof, require investment advisers to vote all proxies. We, however, recognize that there may be confusion regarding this issue. We, therefore, believe SEC Staff interpretive guidance would be helpful.*

   We note that the SEC's 2003 release adopting Rule 206(4)-06 under the Investment Advisers Act requires advisers that have authority to vote proxies to adopt policies and procedures reasonably designed to ensure that the adviser votes proxies in the best interests of clients, disclose to clients information about those policies and procedures, and disclose to clients how they may obtain information on how the adviser has voted

their proxies.[4] Rule 206(4)-6, however, does not contain any language requiring that all proxies be voted. One sentence in the adopting release, taken out of context, could be read to support such a mandate. It states, "The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies."[5] However, the footnote to that sentence immediately clarifies, "As we discuss later in this Release, we do not mean to suggest that an adviser that does not exercise every opportunity to vote a proxy on behalf of its clients would thereby violate its fiduciary obligations to those clients under the Act."[6] Moreover, later in the Release, the Commission explains:

> We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client.

We note that the above language is very similar to the language from a U.S. Department of Labor's 2008 interpretative bulletin addressing proxy voting obligations of ERISA fiduciaries.[7]

2. *We do not believe that, at this time, there is sufficient empirical evidence suggesting that institutional investors are abdicating and outsourcing their voting responsibilities. However, we recognize that there may be disagreement over this issue. We, therefore, believe the SEC should gather, as part of its inspection process, data on the proxy voting practices of investment advisers. This empirical data could provide a factual basis for possible future reforms.*

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[4] 17 CFR 275.206(4)-6; SEC, Final Rule: Proxy Voting by Investment Advisors, Release No. IA - 2106, 79 (Jan. 31, 2003).
[5] SEC, Final Rule: Proxy Voting by Investment Advisers, Release No. IA - 2106, 79 (Jan. 31, 2003).
[6] *Id.* n.3.
[7] 29 C.F.R. § 2509.08–2.

While CII believes some reforms of proxy advisory firms may be appropriate, we oppose regulatory involvement in methodologies used by proxy advisors to determine vote recommendations. We are also concerned about proposed reforms to require proxy advisory firms to submit advance drafts of their reports to the subject companies. We believe that such a mandate could result in at least two problems for shareowners. First, it could create an inherent conflict that may undermine the independence of the report. Second, it could cause unnecessary and costly delays in the distribution of the report.

In addition, we question the need for certain other possible reforms, including some premised on the view that the SEC lacks authority over proxy advisory firms. We believe the SEC currently has significant and sufficient authority over proxy advisory firms, regardless of whether they are registered as investment advisers. For example, we note that while proxy advisers are exempt from the requirement in the SEC's proxy rules that a proxy statement be filed in connection with a solicitation; they remain covered by Rule 14a-9, the SEC's general anti-fraud rule applicable to proxy solicitations. The SEC's 2010 proxy plumbing release discussed this exemption and confirmed that "proxy voting advice remains subject to the prohibition on false and misleading statements in Rule 14a-9."[8] As a result, proxy advisors can be liable under the securities laws for making a materially false or misleading statement in a recommendation. Complaints from issuers that advisors make recommendations based on inaccurate information could be addressed under Rule 14a-9, which both the SEC and private parties can enforce, so long as the information was material to the voting decision.

More generally, we believe that the following three additional factors should be given careful consideration before pursuing any possible proxy advisory reforms, including those generally supported by CII: (1) institutional investor proxy voting practices; (2) the voting power of proxy

[8] SEC, Concept Release on the U.S. Proxy System, Release Nos. 34-62495; IA-3052; IC-29340 (Jul. 14, 2010).

advisory firms; and (3) the market power of proxy advisory firms. The following is a summary of our views on each of those factors:

1. *Institutional Investor Proxy Voting Practices*

Today institutional investors are the dominant owners of U.S. public companies. According to the Conference Board 2010 Institutional Investor Report, institutional investors owned 50.6 percent of the U.S. equity market at the more than 70 percent of the largest U.S. companies and nearly 51 percent of all U.S. equities.[9]

In many cases, institutional ownership is concentrated with a company's largest owners. The Conference Board 2010 report found the 5 largest owners of the 25 largest U.S. companies comprised, on average, nearly 28 percent of the institutional ownership of the companies, while the 25 largest owners comprised, on average, nearly 54 percent of the institutional ownership of the companies.[10]

Institutional investors are not monolithic. They are extremely diverse and include mutual funds, state and local pension funds, and insurance companies. According to the 2010 Conference Board report, mutual funds are the dominant institutional owner, comprising more than 41 percent of all institutional shares and owning 20.9 percent of U.S. equities.[11] In contrast, state and local pension funds comprise 14.8 percent of institutional shares and own 7.5 percent of U.S. equities.[12]

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[9] The Conference Board, *The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition* 5 (Nov. 2010).
[10] *Id.* at 29-46.
[11] *Id.* at 26.
[12] *Id.*

Institutional investors are not identical when it comes to proxy voting. They may vote their shares internally using fund staff. They may delegate proxy voting to asset managers or third-party agents. They may vote based on their own internal proxy voting guidelines. They may vote based on proxy advisor recommendations. In many cases they use the services of proxy advisory firms.

It is important to note that clients of proxy advisory firms are not necessarily voting based on the firms' recommendations. They may have their own guidelines and use the proxy advisory firms' research to assist with their voting.

As indicated earlier, there is no empirical evidence demonstrating that institutional investors blindly follow the recommendations of proxy advisors. Of note, our survey of the largest public pension systems and institutional asset managers found that nearly all have their own proxy voting guidelines and use proxy advisory firms simply for the research; they do not vote based on the advisory firm's voting recommendations.

More specifically, our 10 largest voting members, with total assets aggregating $1.2 trillion, vote based on fund-developed proxy voting guidelines. They generally are clients of one or more proxy advisory firms. However, their use of the firms is generally limited to (1) using the advisory firms' research to assist with their internal proxy voting or (2) delegating the execution of voting to the advisory firms but based on their fund-developed guidelines.

Asset managers also differ in terms of how they handle their proxy voting. In recent years, we have witnessed a sea change in terms of how the largest U.S. asset managers handle their proxy voting responsibilities. Today, the largest U.S. asset managers generally have dedicated staff that specializes in proxy voting. Those firms

have their own proxy voting guidelines; they do not vote based on the advisory firms' recommendations. Similar to the large public fund members of CII, they generally are clients of one or more proxy advisory firms. The advisory firms provide research or vote their proxies based on the managers' guidelines.

2. *Voting Power of Proxy Advisory Firms*

Some observers have criticized proxy advisory firms for having a disproportionate influence on voting outcomes. The estimates of the voting influence of the proxy advisory firms vary.

A study of mutual funds by Professors Stephen Choi, Jill Fisch and Marcel Kahan found that funds accounting for 25 percent of assets virtually always followed management recommendations, while funds accounting for less than 10 percent of the assets exhibited a strong tendency to follow ISS recommendations.[13] Professors Choi, Fisch and Kahan also found that a recommendation from ISS shifts the outcome of a vote by a mere 6 to 10 percent of votes cast.[14] In contrast, a study by Professors David Larcker, Allan L. McCall and Gaizka Ormazabal found that opposition by a proxy advisor results in a "20 percent increase in negative votes cast."[15]

Regardless, interpreting these statistics is difficult. Correlation between voting results and proxy advisor recommendations is not causation and should not be interpreted that votes were cast based solely on the recommendations of the advisory firms. As noted

[13] Stephen Choi et al., *Voting Through Agents: How Mutual Funds Vote on Director Elections* (Aug. 17, 2011); University of Pennsylvania, Institute for Law & Economics Research Paper No. 11-28; NYU Law and Economics Research Paper No. 11-29. Available at SSRN: http://ssrn.com/abstract=1912772 or http://dx.doi.org/10.2139/ssrn.1912772.
[14] Stephen Choi, et al., *The Power of Proxy Advisors: Myth or reality?*, 59 Emory L. J. 869 (2010).
[15] David F. Larcker et al., *Outsourcing Shareholder Voting to Proxy Advisory Firms* 7 (May 10, 2013); Stanford Graduate School of Business Research Paper No. 2105. Available at SSRN: http://ssrn.com/abstract=2101453 or http://dx.doi.org/10.2139/ssrn.2101453.

earlier, CII believes that most large institutions develop and vote based on their own set of voting guidelines. In many cases proxy advisor recommendations are simply consistent with the policies adopted by institutional investors.

This alignment is not surprising given that proxy advisor policies are not developed in a black box, removed from marketplace input. ISS policies, for example, are not developed in a vacuum. Every year ISS conducts an extensive survey on emerging governance and proxy voting issues, gathering perspectives from interested market participants. The survey is followed by in-depth roundtables and a review of relevant empirical evidence or academic literature. Before a new policy is adopted, ISS solicits comments from the public. This extensive due diligence means that ultimately ISS policies reflect the views of the marketplace—not the reverse.

Moreover, empirical evidence does not support the theory that ISS determines the fate of voting outcomes. As illustrated in the table on the following page, in 2012 ISS opposed board nominees 8.5 percent of the time, yet the incidence of a nominee failing to win majority support was less than 0.5 percent. Fewer than one in 10 shareowner proposals requesting an independent board chair receives majority support, despite the fact that ISS recommends in favor of these proposals approximately three times out of every four.

Key proposals and outcomes in 2012

Proposal type	Proposals	Average support	Received less than majority support	Opposed by ISS	Average support if opposed by ISS
Elect director (uncontested)	16,993	95.0%	0.4%	8.5%	82.0%
Advisory vote on executive compensation	2,288	90.8%	2.5%	13.2%	65.0%
Shareowner proposal requesting independent board chair	55	35.6%	92.7%	25.5%	24.1%

Source: ISS Voting Analytics database. Data covers Russell 3,000 with available vote results.

3. *Market Power of Proxy Advisory Firms*

Some observers have criticized proxy advisory firms for having a disproportionate influence on the design of corporate governance. Those observers believe that companies feel compelled to change their corporate governance practices to ensure positive recommendations from the proxy advisory firms. If true, CII believes such a strategy is misguided.

CII believes that companies should be more concerned with the views of its shareowners than the views of the proxy advisory firms. And the largest institutional investor clearly agrees. In January 2012, Blackrock sent a letter to 600 of its biggest holdings, encouraging them to engage with the firm. In the letter, it was reported that CEO Laurence D. Fink stated: "We think it is particularly important to have such discussions - with us and other investors - well in advance of the voting deadlines for

your shareowner meeting and prior to any engagement you may undertake with proxy-advisory firms."[16]

CII agrees that company engagement with shareowners is the best way to gauge shareowner sentiments. In doing so, companies will likely find that on some issues—such as classified boards, poison pills and majority voting for directors—institutional investors frequently have a "one size fits all" approach that is consistent with proxy advisor recommendations. On others, such as "say on pay," they will likely find that institutional investors are comfortable giving companies the flexibility to craft compensation programs to meet unique company needs. Clearly the empirical evidence shows that companies frequently prevail despite "against" recommendations of proxy advisors.

Regardless, the decisions of directors of U.S. companies are broadly and robustly protected under the business judgment rule. As a result, assuming directors acted in good faith and as a reasonable person would have acted, shareowners cannot hold the board liable for its decisions.

And in the context of advisory votes—such as non-binding shareowner proposals and say-on-pay proposals—directors are under no obligation to act as recommended by proxy advisors or approved by shareowners. Certainly a board may face certain consequences—such as a "vote no" campaign against directors or possibly a proxy contest—depending on how shareowners evaluate the board's response. However, that potential outcome is a vital part of checks and balances in the U.S. corporate governance model.

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[16] Christopher Condon & Sree Vidya Bhaktavatsalam, *Fink Leverages BlackRock's $3.5 Trillion in Shareholder Push,* Bloomberg, Jan. 19, 2012.

CII looks forward to continuing to work cooperatively with the Subcommittee, the SEC, the proxy advisory firms and other interested parties in addressing the issues raised by this hearing. Our goal is to ensure that the issues identified are addressed in a thoughtful manner that best serves the needs of long-term investors and the U.S. capital markets.

Thank you Mr. Chairman and Ranking Member Maloney for providing CII the opportunity to submit this statement.

ATTACHMENT

Voting Members
AFL-CIO
AFSCME
Alameda County Employees' Retirement Association
Allstate Corporation
American Express Company
American Federation of Teachers Pension Plan
Amgen
Arkansas Public Employees Retirement System
Assurant Pension Plan
BP America Master Trust for Employee Pension Plans
Bricklayers & Trowel Trades International Pension Fund
Building Trades United Pension Trust Fund - Milwaukee and Vicinity
California Public Employees' Retirement System
California State Teachers' Retirement System
Campbells Soup
Casey Family Programs
Central Laborers' Pension Fund
Central Pension Fund of the International Union of Operating Engineers
CERES
Chevron Master Pension Trust
Coca-Cola Retirement Plan
Colgate-Palmolive Employees' Retirement Income Plan
Communications Workers of America
Connecticut Retirement Plans and Trust Funds
Contra Costa County Employees' Retirement Association
Danaher Retirement & Savings Plan
Delaware Public Employees' Retirement System
District of Columbia Retirement Board
Eastern Illinois University Foundation
Edison International
Educational Employees' Supplementary Retirement System of Fairfax County
EMC
Employees' Retirement Fund of the City of Dallas
Employees Retirement System of Rhode Island
Employees Retirement System of Texas
FedEx
Fire & Police Pension Association of Colorado
Florida State Board of Administration
Forest Laboratories
Gap
General Board of Pension and Health Benefits of the United Methodist Church
General Mills
Hartford Municipal Employees Retirement Fund
Hess Corporation
IAM National Pension Fund
Illinois State Board of Investment
International Brotherhood of Electrical Workers' Pension Benefit Fund
Iowa Public Employees' Retirement System
IUE-CWA Pension Fund
Jacksonville Police & Fire Pension Fund
JetBlue Airways Corporation Retirement Plan
Johnson & Johnson
Laborers National Pension Fund
LifePoint Hospitals Retirement Plan
Limited Brands

LIUNA Staff and Affiliates Pension Fund
Los Angeles City Employees' Retirement System
Los Angeles County Employees Retirement Association
Maine Public Employees Retirement System
Marin County Employees' Retirement Association
Massachusetts Laborers' Health and Welfare Fund
Massachusetts Pension Reserves Investment Management Board
McDonald's Profit Sharing & Savings Plan
Merck
Microsoft Corporation Savings Plus 401(k) Plan
Milwaukee County Employees Retirement System
Milwaukee Employees' Retirement System
Minnesota State Board of Investment
Missouri Public School & Public Education Employee Retirement Systems
Missouri State Employees' Retirement System
Montgomery County Employees' Retirement System
Municipal Employees' Retirement System of Michigan
Nathan Cummings Foundation
National Education Association Employee Retirement Plan
Navy-Marine Corps Relief Society
New Hampshire Retirement System
New Jersey Division of Investment
New York City Employees' Retirement System
New York City Pension Funds
New York State Common Retirement Fund
New York State Teachers' Retirement System
North Carolina Retirement Systems
Ohio Police & Fire Pension Fund
Ohio Public Employees Retirement System
Orange County Employees Retirement System
Pennsylvania Public School Employees' Retirement System
Pennsylvania State Employees' Retirement System
PepsiCo US Pension Plan
Pfizer Retirement Annuity Plan
Plumbers & Pipefitters National Pension Fund
Portico Benefit Services
Prudential Employee Savings Plan
Public Employee Retirement System of Idaho
Public Employees' Retirement Association of Colorado
Retirement Systems of the City of Detroit
Sacramento County Employees' Retirement System
San Francisco City and County Employees' Retirement System
Santa Barbara County Employees' Retirement System
School Employees Retirement System of Ohio
Sealed Air Corporation Retirement Plans
Seattle City Employees' Retirement System

SEIU Affiliates' Supplemental Retirement Savings Plan
SEIU Pension Fund
Sheet Metal Workers' National Pension Fund
Sonoma County Employees Retirement Association
State of Wisconsin Investment Board
State Retirement and Pension System of Maryland
State Teachers Retirement System of Ohio
State Universities Retirement System of Illinois
Target
Teamster Affiliates Pension Plan
Texas Municipal Retirement System
UAW Retiree Medical Benefits Trust
UAW Staff Retirement Income Plan
Union Labor Life Insurance Company
United Brotherhood of Carpenters, Local Unions & Councils Pension Fund
United Food and Commercial Workers International Union Staff Trust Fund
United States Steel and Carnegie Pension Fund
UnitedHealth Group
Vermont Pension Investment Committee
Walt Disney 401(k) Pension Plan
Washington State Investment Board
West Virginia Investment Management Board

Non-Voting Members

Aberdeen Asset Management
Acadian Asset Management
AllianceBernstein
AlphaMetrix
Amalgamated Bank LongView Funds
Andre Baladi & Associates
Angelo, Gordon
APG Asset Management
AST Phoenix Advisors
Australian Council of Super Investors
AXA Investment Managers
Bain Capital
Baring Asset Management
Berman DeValerio
Bernstein Liebhard
Bernstein, Litowitz, Berger & Grossmann
BlackRock
Blue Harbour Group
Broadridge Financial Solutions
CamberView Partners
Canada Pension Plan Investment Board
Canadian Coalition for Good Governance
Capital Group Companies
Capri Capital Partners
Cartica Capital
Center for Audit Quality
Cevian Capital
Cohen Milstein Sellers & Toll
Concinnity Advisors
Credit Suisse Asset Management
D.F. King
Deloitte & Touche
Egan-Jones Rating Company
EnTrust Securities
Entwistle & Cappucci
Ernst & Young
F&C Asset Management
Farient Advisors
Future Fund Management Agency
GAM
Georgeson
Girard Gibbs
Glass Lewis
Global Governance Consulting
GMI
Goldman Sachs Asset Management
Goldman Sachs Investor Relations
Governance for Owners
Grais & Ellsworth
Grant & Eisenhofer
Grant Thornton
Grosvenor Capital Management
Guggenheim Investments
Hagens Berman Sobol Shapiro
Hermes Equity Ownership Services Limited
Hewitt EnnisKnupp
Holland Capital Management
Ichigo Asset Management
ING Investment Management
Innisfree M & A
Investec Asset Management
IR Japan
ISS
J.P. Morgan
Kaplan Fox & Kilsheimer
Kessler Topaz Meltzer & Check
Knight Vinke Asset Management
KPMG
Kroll Bond Rating Agency
Labaton Sucharow
Landmark Partners
Landon Butler
Lawndale Capital Management
Lazard Asset Management
Legal & General Investment Management

Lieff, Cabraser, Heimann & Bernstein
Loomis, Sayles
MacKenzie Partners
Marco Consulting Group
Mesirow Financial
MFS Investment Management
Milberg
MN Services
Morrow
Motley Rice
Nestle SA
Neuberger Berman
New Mountain Capital Group
Norges Bank
Occidental Petroleum
Ontario Pension Board
Ontario Teachers' Pension Plan Board
Pegasus Capital Advisors
Pension Consulting Alliance
Pensions & Investment Research Consultants
Pershing Square Capital Management
PGGM Investments
Piedmont Investment Advisors
Pomerantz Grossman Hufford Dahlstrom & Gross
PRI Association
PricewaterhouseCoopers
Progress Investment Management
Prudential Investment Management
Pyramis Global Advisors
Quantitative Management Associates
Railway Pension Trustee Company
Red Mountain Capital Partners
Reinhart Boerner Van Deuren
Relational Investors
Robbins Geller Rudman & Dowd
RobecoSAM
Robins, Kaplan, Miller & Ciresi
Rock Creek Group
Spector, Roseman, Kodroff & Willis
Standard & Poor's
Standard Life Investments
State Street Corporation
State Street Global Advisors
Stone Harbor Investment Partners
Sumitomo Mitsui Trust Bank Limited
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The Yucaipa Companies
TIAA-CREF
Top Tier Capital Partners
TorreyCove Capital Partners
Trevisan & Associati
Trian Fund Management
UBS Global Asset Management (Americas)
Universities Superannuation Scheme
Virginia Retirement System
Weil, Gotshal & Manges
Wolf Haldenstein Adler Freeman & Herz
XT Capital Partners

Examining the Market Power and Impact of Proxy Advisory Firms

United States House of Representatives
Committee on Financial Services
Subcommittee on Capital Markets and Government Sponsored Enterprises

Statement of
Anne Simpson
Senior Portfolio Manager, Investments
Director of Global Governance
California Public Employees' Retirement System

June 5, 2013

Chairman Garrett, Ranking Member Maloney, and Members of the Committee, on behalf of the California Public Employees' Retirement System (CalPERS), we thank you for convening this hearing. CalPERS is pleased to submit testimony for the record to discuss our proxy voting and engagement efforts.

Some Background on CalPERS

CalPERS is the largest public pension fund in the United States with approximately $266 billion in global assets and equity holdings in over 9,000 companies. CalPERS pays out over $14 billion annually in retirement benefits to more than 1.6 million public employees, retirees, their families and beneficiaries. This is not only an important source of income for those individuals; it also provides a positive economic multiplier to the local economy.[1] We fully understand the virtuous circle between savings, investment and economic growth. That is at the heart of the CalPERS agenda.

As a significant institutional investor with a long-term time horizon, CalPERS fundamentally relies upon the integrity and efficiency of the capital markets. For every dollar that we pay in benefits to our members, 64 cents are generated by investment returns. The financial crisis hit us hard with $70 billion wiped from CalPERS assets. While we are pleased that we have been able to recover these losses over the last several years, we simply cannot afford another decline of that magnitude and there is still much to be done to bring about smart regulation.

In our view, smart regulation should be structured as follows:

First, regulation needs to be complete and coordinated. Innovation in financial markets has led to the development of new financial instruments and pools. Regulation needs to keep pace with financial innovation and the attendant risks in order to be relevant. For example, we believe it is

[1] *See* "The Economic Impacts of CalPERS Pension Payments in 2010", Dr. Robert Fountain, Regional Economic Consultants, (July 2011). ("Every California County benefits from CalPERS retirement payments. In larger urban counties impact is greatest on the total dollar amount of gross regional product. In smaller, rural counties the percentage increase in the gross regional product is greatest. CalPERS payments have a positive impact on jobs throughout the state and in 17 counties they supported more than one percent of the total jobs in their communities.")

imperative that Title VII of Dodd-Frank be implemented meaningfully and comprehensively with an eye toward investor protection and transparency.

Second, regulation needs to allow market players to exercise their proper role and responsibilities. Capitalism was designed to allow the providers of finance a market role in allocating investment, and then holding boards accountable for their stewardship of those funds. This is why shareowner rights are vital to the functioning of markets, including the ability of investors to propose candidates to boards of directors (known in short as 'proxy access') and to remove directors who fail.

Third, regulation needs to ensure transparency, so that markets can play their vital role in pricing risk. Timely, relevant and reliable information is the currency of risk management. Those agencies which have a role in channeling that information need to be fit for that purpose. (Credit ratings agencies were found wanting in this regard.)

Fourth, regulation needs to address conflicts of interest and perverse incentives which can undermine the market's ability to allocate capital effectively. (Short term, risk-free compensation for executives has fueled poor decision taking, as one of example of this).

Fifth, regulation needs to ensure it does not prevent institutional investors from financing legitimate strategies, and taking advantage of new opportunities. Regulation is not there to prevent risk taking, it is there to ensure that risks are disclosed, and can be managed.

Finally, regulation needs to be proportionate. For CalPERS, we balance the additional costs that are required with the potential for catastrophic losses. To those who question whether we can afford to invest in smart regulation, we reply, how can we afford not to? The financial crisis dealt a crippling blow to many investors, and the underlying sub-prime mortgage scandal triggered widespread loss for ordinary people throughout the country. The devastating impact on the real economy is still with us despite the recovery of markets. The costs of regulation need to be weighed against this loss or recognize were we are to improve such.

We see smart regulation as an investment in safety and soundness of financial markets which generate the vast bulk of the returns to our fund. Smart regulation is an investment in the effective functioning of capital markets, which is critical not just to our fund, but to the continuing recovery of the wider economy.

Global Governance

The CalPERS Global Governance Program has evolved over time. In the beginning, CalPERS generally reacted to the anti-takeover actions of corporate managers that undermined the ability of shareowners of the corporate entity – to ensure accountability and fair play. Later the agenda broadened to a wider array of issues which are important to shareowners. CalPERS learned a great deal about how to develop dialogue – how to influence corporate managers, what issues were likely to elicit fellow shareowner support, and where the traditional modes of shareowner/corporation communication were at odds with good governance and performance.

CalPERS turned its focus toward companies with poor financial performance. By centering its attention and resources in this way, CalPERS could demonstrate very specific and tangible results on the value of corporate governance.

What have we learned over the years? We have learned that (a) company managers want to perform well, in both an absolute sense and as compared to their peers; (b) company managers want to adopt long-term strategies and vision, but often do not feel that their shareowners are patient enough; and (c) companies – governed under a structure of full accountability – will have a foundation to underpin their sustained, long-term performance.

We have also learned, that accountable corporate governance means the difference between wallowing for long periods in the depths of the performance cycle, and responding quickly to correct the corporate course. And, in order to encourage companies to make necessary course corrections, we believe shareowners must engage in constructive dialogue with the companies they own. CalPERS regularly meets with corporate directors and officers to discuss corporate strategy and the alignment of interest.

CalPERS Global Principles of Accountable Corporate Governance

In order to advance good governance, CalPERS has developed and annually updates its Global Principles of Accountable Corporate Governance ("CalPERS Principles").[2] CalPERS Principles create the framework by which CalPERS executes its proxy voting responsibilities. In addition, the Principles provide a foundation for supporting the System's corporate engagement and governance initiatives to achieve long-term sustainable risk adjusted investment returns. We also require our external managers to follow these guidelines.

The execution of proxies and voting instructions is an important mechanism by which shareowners can influence a company's operations and corporate governance. It is therefore important for shareowners to exercise their right to participate in the voting and make their decisions based on a full understanding of the information and legal documentation presented to them.

To be clear, CalPERS does not rely on recommendations by any proxy advisory company; to the contrary, CalPERS instead expects proxy advisors to consider governance principles, such as CalPERS Principles, in formulating proxy vote recommendations. These firms carry out useful research and analysis, but for us the source and main point of contact is the company.

CalPERS will vote in favor of or "For", an individual or slate of director nominees up for election that the System believes will effectively oversee CalPERS interests as a shareowner consistent with the CalPERS Principles.

However, CalPERS will withhold its vote from or vote "Against" an individual or slate of director nominees at companies that do not effectively oversee CalPERS interests as a shareowner consistent with CalPERS Principles. CalPERS will also withhold its vote in limited circumstances where a company has consistently demonstrated long-term economic underperformance.

CalPERS Principles have four sections – Core, Domestic, International, and Emerging Markets Principles. Adopting the Principles in its entirety may not be appropriate for every company in the global capital marketplace due to differing developmental stages, competitive environment, regulatory or legal constraints. However, CalPERS does believe the criteria contained in Core Principles can be adopted by companies across all markets - from developed to emerging – in

[2] *See* "Global Principles of Accountable Corporate Governance" as amended Nov. 14, 2011. http://www.calpers-governance.org/docs-sof/principles/2011-11-14-global-principles-of-accountable-corp-gov.pdf

order to establish the foundation for achieving long-term sustainable investment returns through accountable corporate governance structures.

CalPERS Core Principles

CalPERS believes the following Core Principles should be adopted by companies in all markets – from developed to emerging – in order to establish the foundation for achieving long-term sustainable investment returns through accountable corporate governance structures.

1. **Optimizing Shareowner Return:** Corporate governance practices should focus the board's attention on optimizing the company's operating performance, profitability and returns to shareowners.

2. **Accountability:** Directors should be accountable to shareowners and management accountable to directors. To ensure this accountability, directors must be accessible to shareowner inquiry concerning their key decisions affecting the company's strategic direction.

3. **Transparency:** Operating, financial, and governance information about companies must be readily transparent to permit accurate market comparisons; this includes disclosure and transparency of objective globally accepted minimum accounting standards, such as the International Financial Reporting Standards ("IFRS").

4. **One-share/One-vote:** All investors must be treated equitably and upon the principle of one-share/one-vote.

5. **Proxy Materials:** Proxy materials should be written in a manner designed to provide shareowners with the information necessary to make informed voting decisions. Similarly, proxy materials should be distributed in a manner designed to encourage shareowner participation. All shareowner votes, whether cast in person or by proxy, should be formally counted with vote outcomes formally announced.

6. **Code of Best Practices:** Each capital market in which shares are issued and traded should adopt its own Code of Best Practices to promote transparency of information, prevention of harmful labor practices, investor protection, and corporate social responsibility. Where such a code is adopted, companies should disclose to their shareowners whether they are in compliance.

7. **Long-term Vision:** Corporate directors and management should have a long-term strategic vision that, at its core, emphasizes sustained shareowner value. In turn, despite differing investment strategies and tactics, shareowners should encourage corporate management to resist short-term behavior by supporting and rewarding long-term superior returns.

8. **Access to Director Nominations:** Shareowners should have effective access to the director nomination process.

Proxy Voting, 2012 Say on Pay

An example of the positive impact of proxy voting is "Say on Pay". Following the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"), US

companies began holding a non-binding vote on executive compensation ("Say on Pay vote") at least once every three years.

CalPERS believes the use of the Say on Pay votes can have the following positive desired effects:

- Improved communications between shareowners and the company
- Pay-for-performance practices that better align the interests of executives and shareowners through enhanced transparency
- An increased focus on individual company circumstances and sustainable strategic goals in the development and evaluation of executive compensation plans
- Improved accountability to shareowners by ensuring corporate board of directors re-examine and act accordingly in cases where compensation packages may be excessive or where executives have failed to produce value for shareowners.

In 2012, CalPERS voted "AGAINST" 239 of the total 2,439 US Say on Pay proposals. In other words, CalPERS voted "FOR" more than 90% of US compensation proposals. CalPERS has engaged companies to convey outstanding concerns surrounding pay practices, and to date close to half the companies have made positive changes and we have subsequently voted in favor.

In making its decisions on Say on Pay votes, consistent with CalPERS Principles, the following elements are reviewed and contribute to "AGAINST" votes:

- Concerns surrounding pay for performance discipline
- Severance/Change in Control Arrangements (i.e. Singe Triggers and Tax Gross-ups)
- Vesting of equity awards over a term of less than three years
- Compensation design – Incentive Plans that allow repricing of stock options without shareowner approval, evergreen provisions, or reload stock options.
- Incomplete disclosures surrounding compensation policy and design (i.e. how pay is determined and disclosure of metrics and weights).

CalPERS also considers sustainability objectives and disclosures as they relate to executive compensation. We believe executive compensation plans should be designed to support sustainability performance objectives with specific emphasis on risk management, environment, health, and safety standards which are relevant to the company's long-term performance.[3]

"CalPERS Effect" on Targeted Company Share Price

Since 1987, CalPERS has annually identified companies to engage on governance issues[4] with the goal of realigning the interests of companies and shareowners. To measure the relative success of engagement over time, CalPERS has commissioned Wilshire Associates to monetize the program and asses performance results. Wilshire monitors the program and reports annually on the "CalPERS Effect"[5] .

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[3] *See* "Principles and Proxy Voting 2012 CalPERS Say on Pay January 2012-December 2012", http://www.calpers.ca.gov/eip-docs/about/committee-meetings/agendas/invest/201302/item09a-03.pdf

[4] This initiative is the Focus List program. Since 2011 engagement has been confidential.

[5] *See* "Update to The 'CalPERS Effect' on Target Company Share Price," May 3, 2012 http://www.calpers.ca.gov/eip-docs/about/board-cal-agenda/agendas/invest/201211/item09a-03.pdf (at p. 4)

The latest report analyzed stock performance in those 169 companies from the 1999 engagement process through the 2009 engagement process and found:

> For the three years prior to the "initiative date," the engaged companies produced returns that averaged 38.74% below the Russell 1000 Index on a cumulative basis, and 25.40% below the respective Russell 1000 indices. For the five years after the "initiative date," the average engaged companies produced excess returns of 17.08% above the Russell 1000 Index and 13.83% above the respective Russell 1000 sector indices on a cumulative basis.

Recent CalPERS Activity Regarding JP Morgan

CalPERS has been actively engaged on the issue of strengthening governance, particularly board oversight, at JP Morgan. This included supporting a shareholder proposal (calling for JP Morgan to separate the roles of the board chair and CEO) and voting against members of the risk committee who we consider do not have the necessary experience in banking to provide effective oversight. This is consistent with CalPERS Principles regarding the "Role of the Chair"[6] and past proxy voting.[7]

In articulating the role of the chair, CalPERS Principles provide:

> The chair has the crucial function of setting the right context in terms of board agenda, the provision of information to directors, and open boardroom discussions, to enable the directors to generate the effective board debate and discussion and to provide the constructive challenge which the company needs. The chair should work to create and maintain the culture of openness and constructive challenge which allows a diversity of views to be expressed.
>
> This role will be most effectively carried out where the chair of the board is neither the CEO nor a former CEO. Furthermore, the chair should be independent on the date of appointment as chair and should not participate in executive remuneration plans. If the chair is not independent, the company should adopt an appropriate structure to mitigate the problems arising from this. Where the chair is not independent, the company should explain the reasons why this leadership structure is appropriate, and keep the structure under review.
>
> The chair should be available to shareholders for dialogue on key matters of the company's governance and where shareholders have particular concerns. Such meetings may need to be held with the deputy chair or lead independent director either as an alternative or additionally. All board members should make themselves available for meetings with shareholders when an appropriate request is made.

The losses suffered due to the "London Whale" matter have put renewed focus on the need for Board renewal, independent and expert oversight. As a result, CalPERS opposed the re-appointment of three board members who sat on the risk committee. We concluded that each of the nominees lacked the banking experience necessary to properly oversee the risk management system for a bank the size of JP Morgan.

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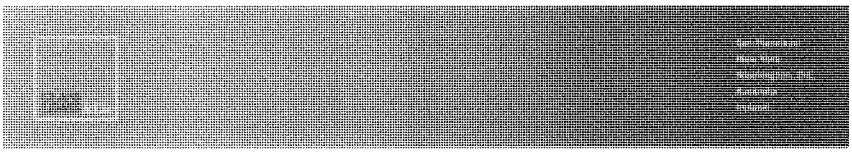
[6] *Supra*, CalPERS Principles, Item 2.5

[7] CalPERS supported a similar resolution to split the roles of the board chair and CEO in 2012.

Conclusions

As discussed above, CalPERS is deeply committed to corporate engagement that helps align corporate interests with those of shareowners. As the providers of capital, we expect boards to be responsive to reasonable governance requests, such as compensation programs that reward long-term performance, independent board chairs and competent board members. We believe complaints about the role of proxy advisory firms from companies that resist constructive engagement with shareowners tends to distract from legitimate concerns about corporate governance.



Written Statement of

Katherine H. Rabin

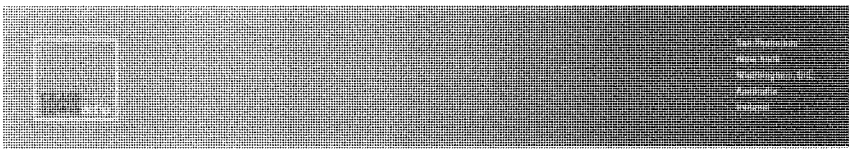
Chief Executive Officer

Glass, Lewis & Co.

June 12, 2013

Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services
United States House of Representatives

"Examining the Market Power and Impact of Proxy Advisory Firms"



Chairman Garrett, Ranking Member Maloney, and Members of the Capital Markets and Government Sponsored Enterprises Subcommittee:

Introduction

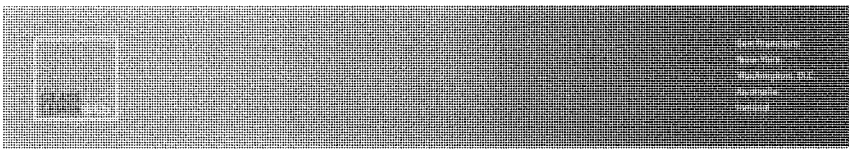
Founded in 2003, Glass Lewis is a leading independent governance services firm that provides proxy voting research, recommendations and custom research and voting services to more than 1,000 clients from around the world. While, for the most part, institutional investor clients use Glass Lewis' research to help them make proxy voting decisions, they also use Glass Lewis research when engaging with companies before and after shareholder meetings. Through Glass Lewis' Web-based vote management system, ViewPoint, Glass Lewis also provides institutional investor clients with the means to receive, reconcile and vote ballots according to custom voting guidelines and record-keep, audit, report and disclose their proxy votes.

In addition to providing services to institutional investors, Glass Lewis sells research reports to the advisors of public companies, such as law firms, consultants and proxy solicitors. Corporate issuers can acquire research reports on their companies directly from Glass Lewis or via Equilar, a provider of executive compensation data.

All clients of all types get access to Glass Lewis research at the same time, upon publication.

Glass Lewis does not provide consulting services to issuers, nor does it provide consulting to shareholders regarding how to gain support from other shareholders for their proposals or dissident nominees in a proxy contest.

Based in San Francisco, California, Glass Lewis' 300-person team provides research and voting services to investors that collectively manage US $15 trillion from branches and subsidiaries in the United States, Europe and Australia.



Background

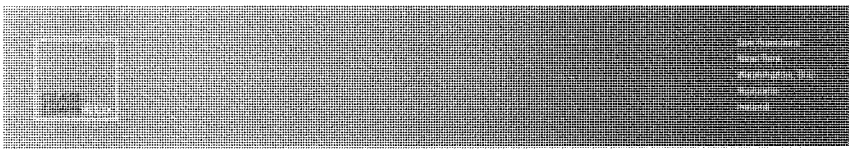
Glass Lewis' clients range in size from investors with a few million dollars in assets under management ("AUM") to those with several trillion dollars US in AUM. These clients seek advice on as few as 20 companies a year in a single market to several thousand equities spanning the globe. It should be noted, however, that the larger institutions comprise the majority of assets under management represented by Glass Lewis' clients and, according to the Conference Board 2010 Institutional Investor Report, institutional investors own over half of all equities in the US. Further, the 25 largest institutional investors control, on average, more than half of all shares of the largest US companies.[1]

In Glass Lewis' experience, among institutional investors of all types (pension funds, mutual funds, asset managers and hedge funds), particularly in North America, Europe and Asia-Pacific, the propensity for robust voting and engagement programs has increased dramatically over the past decade.

This trend is not particular to those with activist or active-investing strategies. Moreover, investors of all types and strategies are increasingly tapping their proxy advisor ("PA") for customized research and voting services. Glass Lewis supports not only the implementation of market-specific custom policies but increasingly is supporting client requirements for issue-specific policies that are nuanced to address sector-, industry- or security-specific guidelines. The trend toward engagement, which has been widespread in Europe, the UK and Australia for many years, is also expanding rapidly in North America. Many Glass Lewis clients across all investor types are now engaging with U.S. companies directly or in collaboration with other investors.

Given the expertise, relationships and investment of time and resources required to constructively engage with issuers, especially for investors with global investments who want to exercise their ownership rights across all holdings, it is in the best interest of the investors' clients and their beneficiaries for investors to make use of the services offered by

[1] The 2010 Institutional Investment Report: Trends in Asset Allocation and Portfolio Composition 29-42, The Conference Board (Nov. 2010).



PAs to complement their own research. PAs ultimately help clients manage voting responsibilities in an accurate, timely and efficient manner.

Statement Highlights

- **Glass Lewis does not apply a one-size-fits-all approach to the analysis of proxies.**

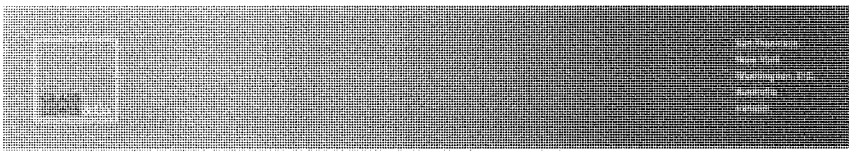
Glass Lewis believes each company should be evaluated based on its own unique facts and circumstances, including performance, size, maturity, governance structure, responsiveness to shareholders, domicile and stock exchange listing.

- **Glass Lewis eliminates, reduces and discloses – proactively, explicitly and comprehensively – potential conflicts, to the greatest extent possible.**

Harvey Pitt's spoken testimony on behalf of the U.S. Chamber of Commerce featured significant factual errors regarding Glass Lewis' conflict management practices. Contrary to Mr. Pitt's statements, Glass Lewis did, in fact, specifically disclose the potential conflict related to Glass Lewis' ownership by the Ontario Teachers' Pension Plan ("OTPP") on the cover of its analysis of the 2012 Canadian Pacific Railway meeting. Mr. Pitt also incorrectly stated that Glass Lewis recommended in the same way that OTPP voted on this meeting, which it did not; Glass Lewis recommended voting in favor of seven company nominated directors, which OTPP voted against. Further, Glass Lewis has a robust, publicly-disclosed conflicts policy, contrary to Mr. Pitt's claim that Glass Lewis has no interest in developing a standard on conflicts. Not only does Glass Lewis have such an interest, we have a robust, transparent policy on conflict elimination, avoidance, management and disclosure.

- **Institutional investors are not "blindly" following proxy advisor recommendations.**

Proxy advisors help investors execute their fiduciary responsibilities with respect to proxy voting. The majority of Glass Lewis' clients, like the vast majority of the world's leading pension funds and asset managers, vote according to their own custom voting policies. The vote decisions derived by implementing those policies may or may not correspond with Glass Lewis recommendations. When they do correspond, it may be for different reasons.



Whether investors elect to follow a PA's recommendations or derive vote decisions based on their own policy, investors retain the right and ability to oversee the process and vote differently than their policy dictates – which they do quite frequently.

- **Existing regulatory frameworks are not appropriate for proxy advisors.**

While Glass Lewis would support the adoption of a regulatory framework tailored to the unique aspects of the proxy advisor industry, we do not believe registration as an investment adviser would be appropriate, given that we do not provide investment advice or manage client assets; nor would it be effective in addressing the main concerns raised in the SEC's 2010 "Concept Release on the U.S. Proxy System" and in the hearing. Furthermore, requiring proxy advisors to comply with regulation that is inappropriate for their activities could further inhibit competition. The Canadian Securities Administrators reached this same conclusion in their "Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" (June 21, 2012).

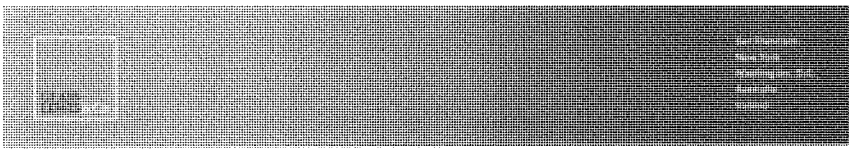
- **An appropriate alternative to regulation is a code of conduct for the PA industry that would address the major issues raised by all stakeholders.**

Glass Lewis is actively working with ISS and other global proxy advisors to develop a code of conduct for the proxy advisory industry. This initiative is being conducted under the auspices of the European Securities and Markets Authority ("ESMA") and the direction of an independent chairman. The code development process will include public hearings. A code is expected to be completed before the 2014 proxy season begins. Glass Lewis has said that it expects to apply the code to its activities globally. (Appended is Glass Lewis' response to the principles for proxy advisors recently announced by ESMA.)

Research Development

Glass Lewis has an obligation to provide high quality, accurate and timely research to its institutional investor clients, based on the analysis of accurate information culled from public disclosure.

Glass Lewis was founded on the principle that each company should be evaluated based on its own unique facts and circumstances, including performance, size, maturity, governance



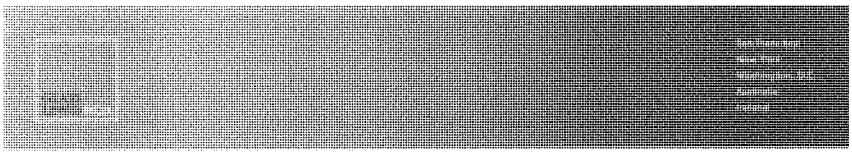
structure, responsiveness to shareholders, domicile and stock exchange listing. Therefore, Glass Lewis has specific policy approaches for each of the 100 countries where it provides research on public companies. These policies are based in large part on the regulatory and market practices of each country, which are monitored and reviewed throughout the year by Glass Lewis' Chief Policy Officer, Associate Vice President of European and Emerging Markets Policy, Vice President of Proxy Research and research directors.

Glass Lewis applies general principles, including promoting director accountability, fostering close alignment of remuneration and performance, and protecting shareholder rights across all of these policies while also closely tailoring them to recognize national and supranational regulations, codes of practice and governance trends, size and development stage of companies, etc.

Glass Lewis' Research Advisory Council ("Council") ensures that Glass Lewis' research consistently meets the quality standards, objectivity and independence criteria set by Glass Lewis' research team leaders. The Council, chaired by Charles A. Bowsher, former Comptroller General of the United States, and supported by Robert McCormick, Glass Lewis' Chief Policy Officer, includes the following experts in the fields of corporate governance, finance, law, management and accounting: Kevin J. Cameron, co-founder and former President of Glass, Lewis & Co.; Jesse Fried, Professor of Law at Harvard Law School; Bengt Hallqvist, Founder of the Brazilian Institute for Corporate Governance; Stephanie LaChance, Vice President, Responsible Investment and Corporate Secretary, PSP Investments; David Nierenberg, President of Nierenberg Investment Management Company; and Ned Regan, Professor, Baruch College.

(Glass Lewis' guidelines can be accessed via the Glass Lewis Issuer Engagement Portal at http://www.glasslewis.com/issuer/guidelines/.)

Glass Lewis engages in discussions with clients, public companies and other relevant industry participants and observers in the development and refinement of its proxy voting policies. Recently, in response to feedback from clients and issuers alike, Glass Lewis launched an enhanced version of its proprietary pay-for-performance ("P4P") model for US companies. A key change to the model was the source of peer group information, which



had been a major point of contention for public companies. The newly enhanced model now features peers derived from company-defined peer groups.

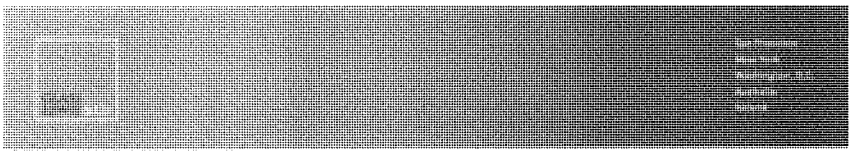
In developing its individual reports, Glass Lewis relies only upon publicly-available information; it will not incorporate into its research information that is not available to clients and other shareholders.

When Glass Lewis analysts require clarification on a particular issue, they will reach out to companies but otherwise generally refrain from meeting privately with companies during the solicitation period, which begins when the proxy statement is released. Throughout the year, however, Glass Lewis hosts "Proxy Talk" conference calls to discuss a meeting, proposal or issue in depth; these calls are open to the public. For example, in the first half of 2013 Glass Lewis hosted Proxy Talks to discuss executive compensation-related issues with the compensation committee chair of Pitney Bowes and with executives of Johnson & Johnson. Glass Lewis also hosted Proxy Talks with three directors of Occidental Petroleum to discuss succession planning at the company and held separate Proxy Talk calls with both the management/directors and shareholder proponents at the Timken Company to discuss a shareholder proposal to split up the company.

How Investors Select, Use and Manage Their Proxy Advisor(s)

Glass Lewis provides institutional investor clients with a range of governance services, including in-depth research on over 20,000 companies, custom policy implementation based on client voting guidelines and proxy vote management services (including ballot collection, ballot reconciliation and vote execution services) as well as a variety of vote reporting services.

The selection of a proxy advisor involves significant analysis and consideration of the advisor's research methodologies, quality of research and technology, experience and expertise of the staff, operations capabilities and internal controls. Issues typically covered by investors during their initial and subsequent, annual due-diligence visits include: voting policies, models used in the analysis of compensation, market-by-market regulatory reviews, research oversight, quality control, research personnel, conflict-management procedures and error management, among other issues.

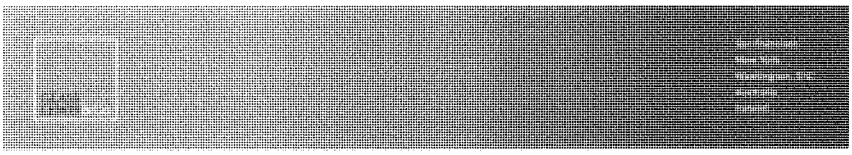


Most Glass Lewis investor clients subscribe to both research and vote management services, while the rest are research-only clients (Research-only clients use a different proxy voting vendor to receive, track and submit ballots and typically buy research from multiple providers.) The majority of Glass Lewis' investor clients – which include the majority of the world's largest public pension funds, asset managers and mutual funds – vote according to a custom policy or via a custom process for reaching vote decisions, in line with what is becoming the standard practice in the market. (See the appended list featuring links to the governance procedures and voting policies of the world's largest investors.) According to the 2012 study by Tapestry Networks and the IRRC Institute, PA guidelines and recommendations are used by investors in different ways. Most respondents to the study said they employ custom policies and may use Glass Lewis recommendations as "a point of reference."[2]

While some clients may generally or even consistently vote according to the Glass Lewis policy, they regularly review and occasionally override Glass Lewis recommendations. Further, custom policy clients – who represent the majority of our clients and control a supermajority of our clients' assets by dollar value – regularly override the recommendations triggered by their custom policies, as their guidelines are designed to allow for review of many issues on a case-by-case basis. The overrides vary in frequency depending on the client and its approach to the relevant issue.

- At 2013 meetings (through May 31, 2013), clients voting according to the Glass Lewis policy elected to override the Glass Lewis recommendations on proposals related to political contributions 9% of the time. Clients voting according to custom policies on this issue overrode their custom recommendations or opted to vote on this issue on a case-by-case basis 20% of the time.

[2] Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers, Tapestry Networks and IRRC Institute, Robyn Bew and Richard Fields (June 2012)



- In the case of proposals calling for the separation of Chairman and CEO at US companies, clients voting according to the Glass Lewis policy overrode the Glass Lewis recommendation 7% of the time. Clients that vote according to a custom policy on this issue overrode their custom recommendations or opted to review and vote on a case-by-case basis 14% of the time.

Advisor Recommendations and Vote Outcomes

Since the issuance of the SEC concept release on the proxy system, much of the debate around PAs has centered on the perceived influence of their voting advice, based on the belief that institutional investors "blindly follow" PA recommendations. Those raising concerns about the influence of PAs point to the correlation between PA advice and vote outcomes and the timing of voting by investors relative to when PAs issue recommendations or corrections as evidence of the purported influence.

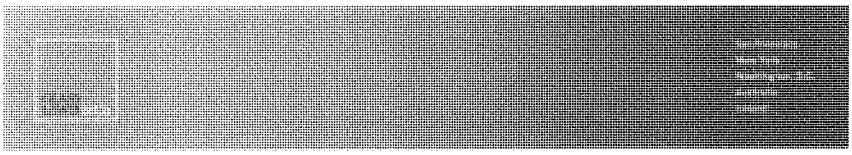
The extent to which PAs influence voting outcomes is overstated. Further, any purported influence is ultimately impossible to empirically measure with a high degree of confidence given the inability to determine to what extent, if any, an investor's vote was actually influenced by one or more PA's recommendations.

For nearly all proposals, there are at most three possible vote options: For, Against/Withhold or Abstain. Given the limited number of voting options and the myriad reasons for arriving at any particular decision, a vote outcome that is the same as a PA's recommendation could be the result of any of the following:

i. *Investor votes the same way as PA but for different reasons.*

   - These reasons are not necessarily transparent, as rationales for voting are generally not disclosed by investors even when votes by investors are disclosed.

ii. *Investor votes the same way as PA for similar reasons, which investors believe are sound and appropriate reasons for their vote decision.*



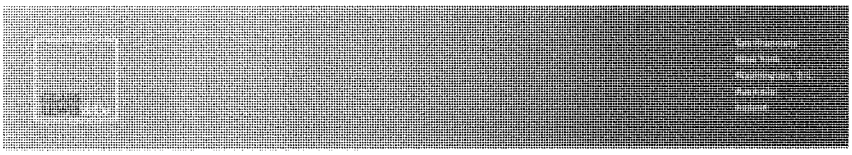
- Investors and PAs often share same views on topics, such as favoring shareholder approval to adopt anti-takeover provisions.

- As explained above, Glass Lewis develops its policies for evaluating governance issues based on a review of the regional and local laws, regulations and governance codes applicable to the companies under coverage. Glass Lewis bases its research on publicly-available information. As such, it is likely that Glass Lewis will often recommend the same way an investor votes, for the same reasons – even when the investor is voting according to a custom policy and not the PA's policy.

iii. *Investor has adopted a PA's policy toward one or more voting issues and, as such, is voting in line with a PA's recommendations for that issue or those issues.*

- The decision to follow a PA's recommendations does not necessarily constitute "blind following" of an advisor's advice. Investors select an advisor based on a thorough review of the advisor's policy, methodologies, research samples, conflict management policies and procedures, as well as an assessment of the experience and qualifications of the advisor's management and analysts. In addition to monitoring votes throughout the year, investors generally conduct annual due-diligence visits to review these same issues and review any questions or concerns that have arisen since their previous visit. Investors retain the right to review and override Glass Lewis recommendations – which they regularly exercise.

The counter-arguments made by issuers to what is stated here often point to the correlation between the timing of the issuance of PA recommendations and when shareholders submit their votes. However, this counter-argument reflects a lack of understanding of the custom policy implementation processes at PAs. At the same time that Glass Lewis publishes its own research, Glass Lewis also implements its clients' custom recommendations, prompting the clients to review and, if necessary, execute their votes. Also, depending on clients' vote instructions regarding when to submit their votes and/or how close to meeting date a correction is made to the analysis on which client votes are



based, any re-voting based on both custom and Glass Lewis policies will happen nearly instantly – as soon as any changes to the research or analysis are published.

Any research that draws conclusions about the impact of PA recommendations on the vote outcome – based on what information is publicly available and the assessment of the timing of votes relative to when PAs publish their reports – is an exercise in conjecture.

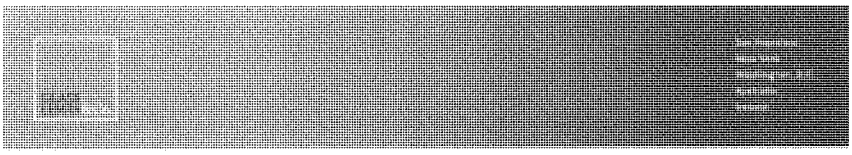
Conflict Management

Proxy research providers, like many companies, may face conflicts in conducting their business. In the case of PAs, potential conflicts generally fall into three categories: (i) business, such as consulting for issuers or selling research reports to asset manager divisions of public companies; (ii) personal, such as where an employee, an employee's relative or an external advisor to the PA serves on a public company board; or (iii) organizational, such as being a public company itself or being owned by an institutional investor.

Glass Lewis believes proxy research providers should eliminate, reduce or disclose conflicts to the greatest extent possible. Glass Lewis maintains strict policies, reviewed and revised annually, governing personal, business and organizational relationships that may present a conflict in independently evaluating companies. The policies, which all employees acknowledge receipt of at the beginning of each year, are disclosed on Glass Lewis' public website. For a complete copy of Glass Lewis' Conflict of Interest Statement, please visit http://www.glasslewis.com/company/disclosure.php.

Glass Lewis provides independent research, analysis and proxy voting advice to institutional investors. Its voting recommendations are based on Glass Lewis' independent determination of what would be in the best interests of long-term investors. As a result, Glass Lewis does not enter into business relationships that conflict with its mission of serving institutional participants in the capital markets with objective advice and services.

However, Glass Lewis recognizes that some conflicts are unavoidable. In those cases, regulatory bodies in many markets have historically required entities, including public companies, to provide significant disclosure about potential conflicts. For example, in many



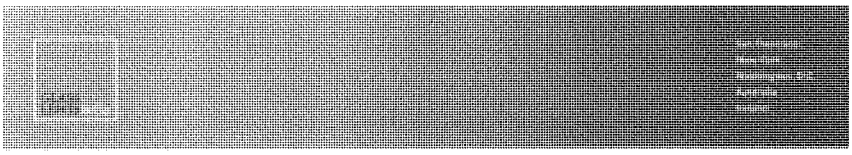
countries issuers must disclose fees paid to audit firms for both audit and non-audit work to highlight any conflicts. Similarly, companies must disclose certain related-party transactions of executives and directors so that investors are able to determine if those conflicts affected the independence and ultimately the performance of the director. Furthermore, regulators, such as the SEC, require companies to disclose certain fees paid to compensation consultants as an indication of potential conflicts when the consultants provide additional services to the company.

Research providers should be required to proactively provide robust and specific disclosure about their potential conflicts. Only in this way can the users of the research make a determination if the research is tainted by the conflict.

Since conflicts can arise not just in the provision of services but even in the solicitation of them, the cleanest and most effective way to manage conflicts is to eliminate them where possible. Recognizing this, Glass Lewis was founded with the core policy of not providing any consulting services to corporate issuers. Glass Lewis believes PAs that do provide consulting services to companies on which they subsequently write research reports should disclose the extent of their business relationships proactively, specifically and in detail, as should the public companies receiving such consulting. In addition, Glass Lewis does not consult with investors on how to gain shareholder support for those shareholders' initiatives.

Glass Lewis takes precautions to ensure its research is objective at all times and under all circumstances. As an indirect wholly-owned subsidiary of OTPP, Glass Lewis maintains its independence and operates completely separate from OTPP. OTPP is not involved in the day-to-day management of Glass Lewis and is excluded from any involvement in how Glass Lewis formulates voting policies and recommendations. The proxy voting and related corporate governance policies of Glass Lewis enforce that separation from OTPP.

As part of Glass Lewis' continued commitment to its customers, Glass Lewis' independent Research Advisory Council ensures that Glass Lewis' research consistently meets the quality standards, objectivity and independence criteria set by Glass Lewis' research team leaders.



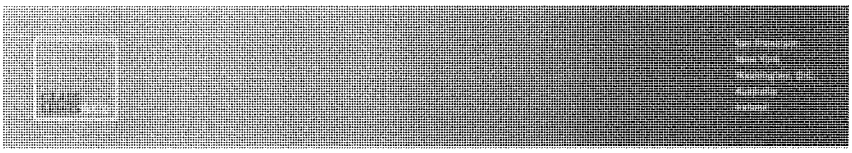
As discussed above, Glass Lewis does not offer consulting services to public corporations or directors. Glass Lewis is not in the business of advising public companies on their governance structures or conduct, and does not use its position as trusted advisor to institutional investors to win consulting mandates with issuers.

In certain instances, Glass Lewis may provide its research reports to investment managers that may be affiliated with publicly-held companies. In such cases, however, Glass Lewis discloses any such relationship on the cover of the relevant research report. Moreover, Glass Lewis makes its research reports generally available post-publication.

Furthermore, Glass Lewis maintains additional conflict disclosure and avoidance safeguards to mitigate potential conflicts. These apply when: (i) a Glass Lewis employee, or relative of an employee of Glass Lewis, or any of its subsidiaries, a member of the Council, or a member of Glass Lewis' Strategic Committee serves as an executive or director of a public company; (ii) an investment manager customer is a public company or a division of a public company; (iii) a Glass Lewis customer submits a shareholder proposal or is a dissident shareholder in a proxy contest; (iv) OTPP holds a stake in a company significant enough to be subject to public disclosure rules regarding its ownership in accordance with the local market's regulatory requirements; or (v) OTPP discloses its ownership stake in a company, through OTPP's published annual report.

In each of the instances described above, Glass Lewis makes full, specific and prominent disclosure to its customers in the disclosure section of the relevant research report. Just as companies bear the burden to disclose potential conflicts, Glass Lewis recognizes that the onus should be on the conflicted party to disclose any potential conflicts. In addition, where any employee or relative of an employee is an executive or director of a public company, that relationship is not only disclosed but that employee plays no role in the analysis or voting recommendations of that company.

Glass Lewis believes examining the treatment of other conflicts is illustrative for determining the precedent for successful examples of conflict avoidance and disclosure. One example of an industry where the current solution was found ineffective is the credit ratings industry. Some credit rating agencies, which in effect sell their ratings to the companies they rate, have been found to have altered ratings at the request of issuers. This



ability to potentially negotiate a better rating creates the opportunity to "game" the system.

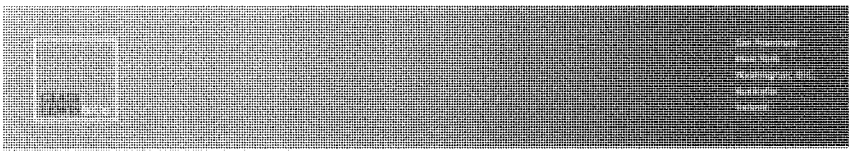
On the other hand, the treatment of audit firm conflicts under the Sarbanes-Oxley Act in the United States provides an example of an effective means of limiting conflicts by significantly limiting an audit firm's ability to work for both the audit committee and company executives, coupled with specific disclosure requirements.

Glass Lewis provides specific, prominent disclosure of all potential conflicts, including those arising from Glass Lewis being owned by OTPP. In Mr. Pitt's live testimony on June 5, he claimed that with regard to the vote at the Canadian Pacific Railway proxy contest in 2012, Glass Lewis issued recommendations in its report but did not disclose the conflict other than with "vague, generic" language. That was not the case, as there was a prominent, specific note on the front page of the report highlighting OTPP's ownership of Glass Lewis.

This erroneous claim compounds the error made by the US Chamber of Commerce ("the Chamber") in its letter to the SEC. The Chamber indicated that Glass Lewis' decision to recommend voting in favor of the dissidents at the Canadian Pacific Railway meeting, after it became public that OTPP was voting for the dissidents, was evidence that Glass Lewis' recommendation was designed to benefit OTPP's "unique interests" (presumably as opposed to the interest of other shareholders who also supported the dissidents, in an overwhelming fashion). The Chamber further claimed in the same letter that the Glass Lewis recommendations and OTPP's vote demonstrated a strong possibility that the recommendations and vote were "being coordinated in some manner," an outrageous and unsubstantiated charge. (Appended to this statement is the response from Glass Lewis to the US Chamber of Commerce's letter to the SEC, http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/2012-5.30-Glass-Lewis-letter-release.pdf). This baseless charge is further debunked by the fact that while Glass Lewis recommended voting in favor of seven management nominees, OTPP voted against them all.

Accuracy, Corrections and Engagement

Glass Lewis recognizes that clients rely on the information and analysis contained in the Proxy Paper research reports to help them make informed voting decisions. Therefore, the



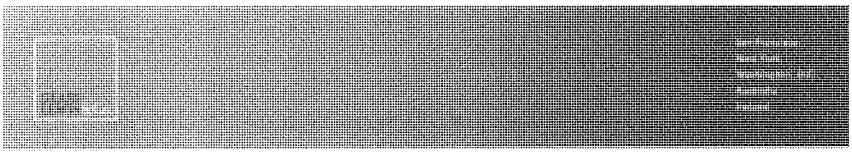
firm has developed robust and comprehensive training, oversight and editing processes to ensure a high level of accuracy and data integrity in the reports. Another control is that analysts' authority to publish Proxy Papers, i.e. the final step in providing them to clients, is limited based on the issues covered in the report as well as the analyst's specialty, seniority and expertise. For example, only senior members of the Mergers & Acquisitions team are authorized to publish reports on such financial transactions.

Prior to publication to clients, all draft reports are reviewed and edited by at least two additional senior analysts and managers up to and including a Director of Research, a Vice President of Research, the Managing Director of Mergers & Acquisition Analysis and/or the Chief Policy Officer.

Glass Lewis evaluates all concerns including purported errors raised by corporate issuers subject to the Proxy Paper research reports. Issuers can submit queries, requests for meetings and notifications of subsequent filings and additional information as well as what they perceive to be errors via our Issuer Engagement Portal. When Glass Lewis is notified of a purported error, it immediately reviews the report and, if there is a reasonable likelihood the report will require revising, removes the report from its published status so no additional clients can access it. However, often what a corporation indicates is an error is ultimately a difference in interpretation or opinion regarding a certain issue, and therefore requires no correction. As of May 31, 2013, material errors in Glass Lewis' research (brought to our attention by the company, its advisors or through subsequent disclosure) that resulted in a change to the Glass Lewis recommendation represented one-tenth of 1% of the items up for vote at US companies analyzed by Glass Lewis.

In most markets, Glass Lewis publishes its reports well in advance of meeting date; in the US an average of three weeks prior to the meeting. This provides sufficient time for Glass Lewis to receive and respond to notifications of any factual errors. Just as Glass Lewis discloses specific information about conflicts in the disclosure section of its reports, the exact nature of all report updates and revisions are described, including changes to recommendations.

When a report is updated to reflect new disclosure or the correction of an error, Glass Lewis notifies all clients that have accessed the report or that have ballots in the system for the



meeting tied to that report – whether or not the update affected Glass Lewis and/or clients' custom recommendations.

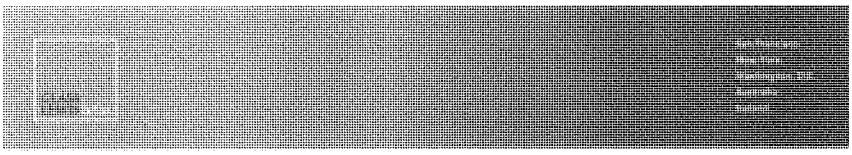
Outside the solicitation and proxy season blackout periods, Glass Lewis is open to meeting with companies to discuss research policies and methodologies, as well as perspectives on both general topics and issues specific to the company. Indeed, Glass Lewis meets with hundreds of public companies each year in person or by phone. Companies can request meetings via the Glass Lewis public website at http://www.glasslewis.com/issuer/.

In accordance with feedback from clients, Glass Lewis does not believe it is in the best interests of investors to provide previews of PA analysis to the subject companies. This type of "consultation" would open Glass Lewis up to being lobbied by companies, since companies could use this communication opportunity to push for a change in a recommendation against management. Furthermore, from a practical perspective, given the often tight timeframe between the issuance of the proxy statement and the vote deadline, any delay in the distribution of reports to investors would further limit the time available for them to review the analysis, discuss in internal meetings (many clients maintain proxy committees), engage with companies and make fully informed voting decisions.

Glass Lewis is currently exploring how to provide issuers with access to the data used in the development of its analysis, on a company-by-company basis, for review by companies prior to issuing reports. Until that time, Glass Lewis does not intend to make any of its data or research available prior to publication to clients. For more information on Glass Lewis' Corporate Engagement Policy, go to: http://www.glasslewis.com/for-issuers/glass-lewis-corporate-engagement-policy/.

Glass Lewis typically publishes its reports on annual general meetings three weeks prior to meeting date. Publishing times may vary depending on the timing of disclosure and the types of issues up for vote. Analysis on mergers and acquisitions and other financial transactions, for example, is generally published closer to meeting date. For information on how to access individual Glass Lewis reports upon publication, go to "Accessing Glass Lewis Reports" at http://www.glasslewis.com/issuer/.

Glass Lewis maintains a robust employee code of ethics, receipt and understanding of which is acknowledged annually by each employee. The code addresses conflicts,



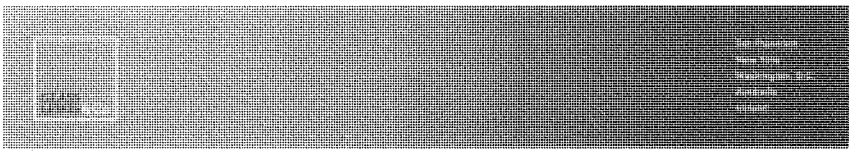
confidential treatment of client information and trade reporting, among many other practices.

Views on Regulation of Proxy Advisors

Since the issuance of the SEC proxy system concept release, the Canadian Securities Administrators ("CSA") and the European Securities and Markets Authority ("ESMA") has each issued similar releases regarding the PA industry. (Appended are Glass Lewis' letter to the SEC responding to certain questions raised by the U.S. Chamber of Commerce and our response to the CSA's consultation paper.) The CSA's paper contained an assessment of the potential regulatory frameworks considered in their release and determined that (i) PAs should not be required to register as "advisers;" (ii) the work of PAs does not amount to "soliciting" proxies; and (iii) PAs should not be regulated under the framework contemplated for credit rating agencies.

Glass Lewis recognizes that different laws and regulations apply in Canada than in the United States. However, Glass Lewis believes the CSA's conclusions outlined in its "Consultation Paper 25-401: Potential Regulation of Proxy Advisory Firms" (June 21, 2012) with respect to the appropriateness of investment adviser registration of proxy advisors are relevant to the U.S. situation:

> "In our view, proxy advisory firms are not in the business of advising in the purchase or sale of securities, and therefore, should not be required to register as "advisers" under our securities acts. Although proxy advisory firms provide advice when they make vote recommendations to their clients regarding proposals put to shareholders at shareholders' meetings, this advice is most often not directly with respect to an investment in securities or the purchase or sale of securities.
>
> Moreover, the activities of proxy advisory firms do not fit within the principles underlying the registration regime since these activities have little connection with registration in the traditional sense and are remote from the protection of retail investors.
>
> As our objective would be to regulate proxy advisory firms as market participants and not necessarily to specifically regulate their relationships with clients, the application of the principles of registration would pose a challenge.



An additional difficulty is that the registration requirements and the registrant obligations under NI 31-103 (National Instrument 31-103 governs registration requirements and exemptions for relevant entities in Canada) are not tailored to the business of proxy advisory firms.

If we chose to regulate proxy advisory firms as advisers, we would have to consider whether our current fitness requirements for registered advisers based on the principles of proficiency, integrity and solvency are appropriate. Once registered, proxy advisory firms would then be subject to our oversight through our compliance review programme and our enforcement function."

The CSA paper also concluded the following with respect to whether proxy advisor activities constitute the "soliciting" of proxies:

"We do not believe that the activities of proxy advisory firms amount to "soliciting" proxies nor is preparing and sending a proxy circular the proper response to the concerns raised. Our view is supported by the fact that proxy voting advice is not considered as soliciting under our existing proxy solicitation rules, as evidenced by the exception to the definition of "solicit". Proxy solicitation rules should only apply if the person is actually soliciting proxies.

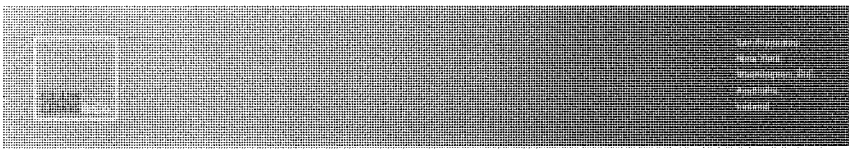
Furthermore, if we chose to regulate proxy advisory firms through the proxy solicitation requirements in NI 51-102 (National Instrument 51-102 governs continuous disclosure obligations including those relating to proxy solicitation for entities in Canada), we would be creating a regulatory framework for proxy advisors in a rule that is designed to apply mainly to reporting issuers.

For these reasons, we do not believe that the proxy solicitation regulatory framework contained in NI 51-102 is an appropriate securities regulatory framework for proxy advisors."

Glass Lewis believes that any binding or quasi-binding regulation of PAs would be inappropriate and potentially harmful. The reasons for this view include:

- *Investors are fiduciaries that already hold their advisors accountable for the quality and accuracy of the services they provide. ... The market does work.*

Institutional investors have a fiduciary responsibility to vote proxies in a manner that is in the best interests of their beneficiaries. It has been Glass Lewis' experience, as a provider of research, proxy voting and other governance services to nearly hundreds of investors across the globe, that investors take this responsibility very seriously.



Institutional investors hold PAs accountable for providing objective, accurate and high-quality research services that are developed and delivered in accordance with client instructions. In addition, PAs must meet the requirements set forth by their clients for managing and disclosing conflicts of interest.

If an advisor fails to meet the standards and requirements set forth by the client, that client has the option to select another provider.

- *PAs are just one participant in a large voting chain, which includes issuers, ballot distributors, custodians, sub-custodians and registrars, among others.*

Research development by PAs is dependent on the activities of several members of the voting chain. It would be inappropriate and potentially harmful to investors if any regulator were to mandate quasi-binding or binding instruments without mandating related instruments for other participants in the chain.

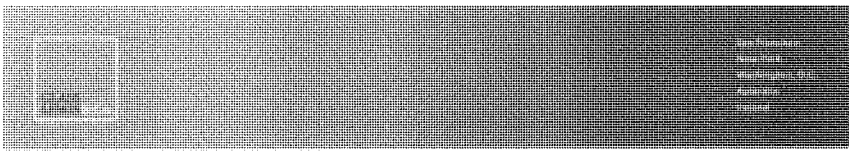
- *A proliferation of differing binding or quasi-binding regulatory instruments in different jurisdictions would be potentially burdensome for both investors and PAs, impacting shareholder rights and creating barriers to entry into the proxy advisory industry.*

Glass Lewis is working with ISS and other key members of the global proxy advisory industry to develop an industry code of conduct that could apply globally and would govern policy and research development; conflict management and disclosure; and transparency. Information on this code is attached.

Conclusion

Glass Lewis welcomes the opportunity to work with the Subcommittee and other interested parties to find the appropriate ways to address issues raised in the hearing that relate to the proxy advisory industry in a manner that best serves the needs of long-term investors and the U.S. capital markets. Indeed, we look forward to getting feedback from all stakeholders on the industry code of conduct currently under development.

Thank you, Mr. Chairman and Ranking Member Maloney for providing Glass Lewis with the opportunity to submit this statement.



21 March 2013

Glass Lewis Supports ESMA Principles for Proxy Advisors

Global proxy advisors are working to develop an industry code of conduct

Since the 2010 release of the SEC's concept release on the U.S. proxy system, Glass Lewis has been actively engaged with regulators, investors, issuers and other stakeholders across the globe regarding the role of proxy advisors.

In responses to three subsequent consultations, issued in 2012 by the European Securities and Markets Authority ("ESMA"), Canadian Securities Administrators ("CSA") and the Corporations and Markets Advisory Committee of Australia ("CAMAC"), Glass Lewis has consistently expressed the view that a market-based solution, in particular a code of best practices developed by proxy advisors, is the appropriate means to address the relevant issues raised in these consultations – namely conflict management, transparency of policies and methodologies, and engagement.

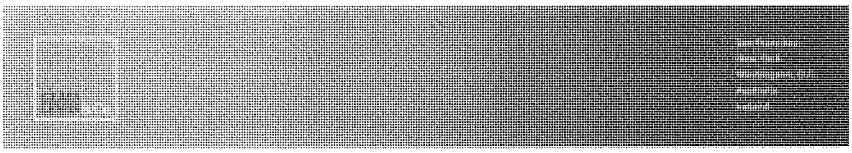
Glass Lewis is actively working with a group of proxy advisors operating in Europe to develop such a code. Given that the principles outlined in the ESMA Feedback Statement are broadly applicable to all markets, it is Glass Lewis' intention to apply the code under development to activities globally, not just in Europe.

Below are the ESMA principles for proxy advisors and summaries of Glass Lewis' views on the related issues. More detailed information on Glass Lewis' views is contained in the Glass Lewis consultation paper responses, which are available at http://www.glasslewis.com/about-glass-lewis/press-releases/.

1. Identifying, disclosing and managing conflicts of interest

Principle: *Proxy advisors should seek to avoid conflicts of interest with their clients. Where a conflict effectively or potentially arises the proxy advisor should adequately disclose this conflict and the steps which it has taken to mitigate the conflict, in order that the client can make a properly informed assessment of the proxy advisor's advice.*

ESMA Rationale: Considering their important role in the voting process, proxy advisors can, like many intermediaries, be subject to conflicts of interest. They should therefore identify, disclose and manage these conflicts to ensure the independence of their advice. ESMA learned from the market consultation that market participants are concerned regarding potential conflicts of interests, in particular about circumstances where: (i) the proxy advisor provides services both to the investor and to the issuer; and (ii) where the proxy advisor is owned by an institutional investor or by a listed company to whom, or about whom, the proxy advisor may be providing advice.



Glass Lewis Views: Proxy advisors ("PAs"), like many companies, may face conflicts in conducting their business. In the case of PAs, potential conflicts generally fall into three categories: (i) business, such as consulting for issuers or selling research reports to asset manager divisions of public companies; (ii) personal, where an employee, an employee's relative or an external advisor to the PA serves on a public company board; or (iii) organizational, such as being a public company itself or being owned by an institutional investor.

Glass Lewis believes PAs should eliminate, reduce or disclose conflicts to the greatest extent possible. Glass Lewis maintains strict policies, reviewed and revised annually, governing personal, business and organizational relationships that may present a conflict in independently evaluating companies. The policies, which all employees acknowledge receipt of at the beginning of each year, are disclosed on Glass Lewis' public website. For a complete copy of Glass Lewis' Conflict of Interest Statement, please visit http://www.glasslewis.com/company/disclosure.php.

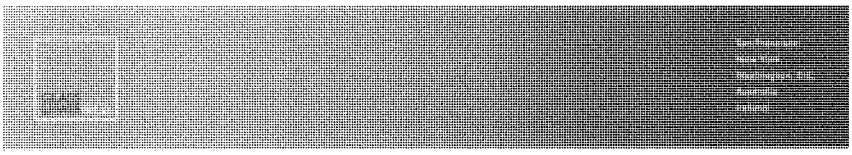
Since conflicts can arise not just in the provision of services but even in the solicitation of them, the cleanest and most effective way to manage conflicts is to eliminate them where possible. Recognizing this, Glass Lewis was founded with the core policy of not providing any consulting services to corporate issuers.

Glass Lewis takes precautions to ensure its research is objective at all times and under all circumstances. As an indirect wholly-owned subsidiary of Ontario Teachers Pension Plan ("OTPP"), Glass Lewis maintains its independence and operates completely separate from OTPP. OTPP is not involved in the day-to-day management of Glass Lewis and is excluded from any involvement in how Glass Lewis formulates voting policies and recommendations.

The proxy voting and related corporate governance policies of Glass Lewis enforce that separation from OTPP. As part of Glass Lewis' continued commitment to its customers, Glass Lewis has an independent Research Advisory Council ("Council"). The Council ensures that Glass Lewis policies and guidelines reflect current and developing trends, including regulatory changes and market practices, and that Glass Lewis research meets the highest standards of quality, objectivity and independence.

Although Glass Lewis is not in the business of advising public companies on their governance structures or conduct, Glass Lewis may provide its research reports to investment managers that are affiliated with publicly-held companies. In such cases, however, Glass Lewis discloses with specificity any such relationship in the relevant research report.

Furthermore, Glass Lewis maintains additional conflict disclosure and avoidance safeguards to mitigate potential conflicts. These apply when: (i) a Glass Lewis employee, or relative of an employee of Glass Lewis, or any of its subsidiaries, a member of the Council, or a member of Glass Lewis' Strategic Committee serves as an executive or director of a public company; (ii) an investment manager customer is a public company or a division of a public company; (iii) a Glass Lewis customer submits a shareholder



proposal or is a dissident shareholder in a proxy contest; and (iv) when Glass Lewis provides coverage on a company in which OTPP holds a stake significant enough to be subject to public disclosure rules regarding its ownership in accordance with the local market's regulatory requirements; or Glass Lewis becomes aware of OTPP's disclosure to the public of its ownership stake in such company, through OTPP's published annual report or any other publicly available information disclosed by OTPP.

In each of the instances described above, Glass Lewis makes full, specific and prominent disclosure to its customers in the relevant research report. Just as companies bear the burden to disclose potential conflicts, Glass Lewis recognizes that the onus should be on the conflicted party to disclose any potential conflicts. In addition, where any employee or relative of an employee is an executive or director of a public company, that relationship is not only disclosed but that employee plays no role in the analysis or voting recommendations of that company.

2. Fostering transparency to ensure the accuracy and reliability of the advice

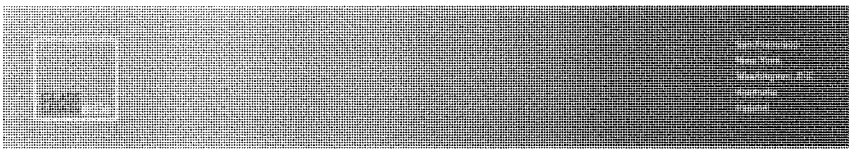
Principle: *Proxy advisors should provide investors with information on the process they have used in making their general and specific recommendations and any limitations or conditions to be taken into account on the advice provided so that investors can make appropriate use of the proxy advice.*

ESMA Rationale: Proxy advisors may have systems and controls in place that guarantee proper and sound advice. These systems and controls may increase the reliability of the advice and enlarge accuracy. ESMA learned from the market consultation that the market would specifically favour greater transparency of these systems and controls, including, but not limited to (i) disclosure of general voting policies and methodologies, (ii) consideration of local market conditions and (iii) providing information on engagement with issuers.

Glass Lewis Views: Glass Lewis reports are typically available three weeks prior to meeting date, which provides sufficient time for Glass Lewis to receive and respond to notifications of potential factual errors. (Publishing times may vary depending on the timing of the disclosure and the types of issues up for vote, such as mergers and acquisitions or control contests.)

Information on how to access individual Glass Lewis reports upon publication is available via the Issuer Engagement Portal, at http://www.glasslewis.com/issuer/, under "Accessing Glass Lewis Reports." Information on how to report a possible factual error is available at the same location under "Reporting a Data Discrepancy."

Just as Glass Lewis discloses information about potential conflicts on the front page of its reports, the exact nature of all report updates and revisions are described in the reports, including changes to recommendations. When a report is updated to reflect new disclosure or the correction of an error, Glass Lewis notifies all clients that have accessed the report or that have ballots in the system for the



meeting tied to that report – whether or not the update affected Glass Lewis and/or clients' custom recommendations.

2.i. Disclosing general voting policies and methodologies

Principle: *Proxy advisors should, where appropriate in each context, disclose both publicly and to client investors the methodology and the nature of the specific information sources they use in making their voting recommendations, and how their voting policies and guidelines are applied to produce voting recommendations.*

ESMA Rationale: To allow all stakeholders, especially investors and issuers, to better assess the accuracy and reliability of the proxy advisor's services, proxy advisors are expected to be transparent on their voting policy and on the main characteristics of the methodology they apply, which form the rationale of their recommendations. This is also in line with the overall message that ESMA received from the market consultation for greater transparency, where appropriate, by proxy advisors about their activities and processes.

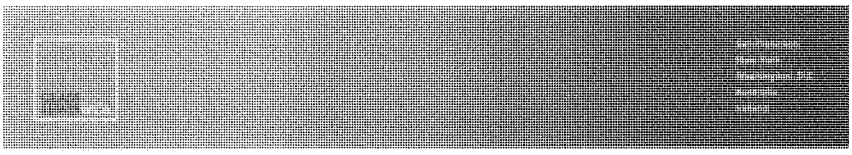
Glass Lewis Views: Glass Lewis guidelines are available at http://www.glasslewis.com/resource/. In addition, information on Glass Lewis' approach to analyzing financial transactions is available at http://www.glasslewis.com/issuer/evaluation-of-financial-transactions/. Also, information on Glass Lewis methodologies for evaluating pay for performance, advisory votes on compensation ("Say on Pay") and equity-based compensation is available at http://www.glasslewis.com/issuer/compensation-analysis/.

In developing its individual reports, Glass Lewis relies only upon publicly-available information; it will not incorporate into its research information that is not available to clients and other shareholders. When Glass Lewis analysts require clarification on a particular issue, they will reach out to companies but otherwise generally refrain from meeting privately with companies during the solicitation period, which begins when the proxy circular is released. Throughout the year, however, Glass Lewis hosts "Proxy Talk" conference calls for investors to discuss a meeting, proposal or issue in depth; depending on the topic, these calls may be open to the public.

2.ii. Considering local market conditions

Principle: *Proxy advisors should be aware of the local market, legal and regulatory conditions to which issuers are subject, and disclose whether/how these conditions are taken into due account in the proxy advisor's advice.*

ESMA Rationale: Proxy advice generally is a cross-border activity which requires the awareness of different laws, rules and regulations governing issuers' activities in each relevant jurisdiction. Therefore proxy advisors, as ESMA also learned from the market consultation, are expected to have a proper



knowledge of the national and regional context, irrespective of whether proxy advisors choose to apply an international benchmark, or their client's own preferences/policies, in forming their opinion of individual meeting resolutions. Such knowledge of local/regional conditions is needed in order to develop an accurate voting policy, and, as a result, an appropriate advice.

Glass Lewis Views: Glass Lewis was founded on the principle that each company should be evaluated based on its own unique facts and circumstances, including performance, size, maturity, governance structure, responsiveness to shareholders and, last but not least, location. Therefore, Glass Lewis has policy approaches for each of the countries where it provides research on public companies. These policies are based in large part on the regulatory and market practices of each country, which are monitored and reviewed throughout the year by Glass Lewis' Chief Policy Officer, Associate Vice President of European and Emerging Markets Policy, Vice President of Proxy Research and research directors. Glass Lewis applies general principles, including promoting director accountability, fostering close alignment of remuneration and performance, and protecting shareholder rights across all of these policies while also closely tailoring them to recognize national and supranational regulations, codes of practice and governance trends, size and development stage of companies, etc.

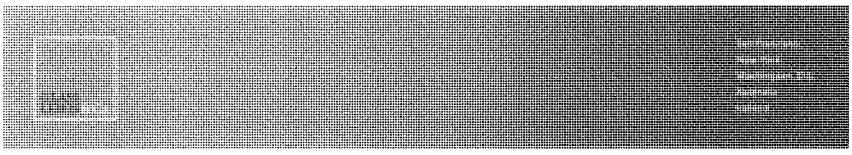
Glass Lewis engages in discussions with clients, public companies and other relevant industry participants and observers in the development and refinement of proxy voting policies. In 2012, in response to feedback from clients and issuers alike, Glass Lewis launched an enhanced version of its proprietary pay-for-performance ("P4P") model for U.S. companies. A key change to the model was the source of peer group information, which had been a major point of contention for public companies.

The newly enhanced model now features peers derived from company-defined peer groups. Glass Lewis displays the peers used in its analysis and identifies any differences between the peer group used in the model and companies' self-selected peer groups.

2.iii. Providing information on engagement with issuers

Principle: *Proxy advisors should inform investors about their dialogue with issuers, and of the nature of that dialogue.*

ESMA Rationale: Proxy advisors can choose whether or not to have a dialogue with issuers. If they do choose to have such a dialogue, it is up to the proxy advisor what should be the timing, frequency, intensity and format for this dialogue. A proxy advisor should disclose to investors whether there is a dialogue between the proxy advisor and an issuer. Where such a dialogue takes place, it should inform investors about the nature of the dialogue, which may also include informing clients of the outcome of that dialogue. ESMA learned from the market consultation that some proxy advisors do not conduct dialogue with issuers. When there is dialogue, the nature and degree of that dialogue differs significantly among proxy advisors, as well as the level of transparency on the fact that dialogue is taking place.



Glass Lewis Views: Dialogue between investors and companies can be an effective means for investors and companies to gain a better understanding of each other's goals and strategies and is therefore to be encouraged. This dialogue should be undertaken year-round to develop meaningful relationships and ensure a high level of trust. Glass Lewis often engages in discussions with companies outside the proxy season, but prefers not to have off-the-record discussions with companies during the proxy solicitation period to ensure the independence of its research and advice – something that is highly valued by clients – and to avoid receiving information, including material non-public information, not otherwise available to shareholders. It has been Glass Lewis' experience that issuers generally try to use solicitation-period discussions to lobby for the support of a recommendation or to learn what changes Glass Lewis requires in order to "win" Glass Lewis support for items up for vote. This is not appropriate, given that Glass Lewis is not empowered to negotiate on behalf of clients, who often hold different or even opposing points of view on certain issues.

Glass Lewis' research professionals analyze public company filings, specifically proxy statements and financial statements, as well as multiple external original research sources to evaluate board effectiveness and company risk profiles. If Glass Lewis analysts require clarification on a particular issue, they will reach out to companies.

As previously stated, throughout the year and very frequently during the proxy season, Glass Lewis hosts "Proxy Talk" conference calls with issuers and shareholders, as relevant, to discuss a meeting, proposal or issue in depth. Glass Lewis' clients and other shareholders are invited to listen to the call and submit questions to the speakers, with representatives from Glass Lewis serving as moderators. Proxy Talks are held prior to the publishing of research in order to glean additional information for Glass Lewis' analysis and to provide more information for clients. For certain meetings, such as control contests, Glass Lewis will host separate Proxy Talks with both sides, i.e. management and the dissident shareholder.

Glass Lewis encourages corporate issuers to contact Glass Lewis via the Issuer Engagement Portal. Glass Lewis designed the Issuer Engagement Portal to facilitate and track communication with companies, including arranging calls, meetings and Proxy Talk conference calls. The portal also provides a means for companies to comment and provide feedback on reports and to notify Glass Lewis of subsequent proxy circulars and press releases, as well as perceived errors or omissions in Glass Lewis reports.

Proxy Voting Policies and Procedures of World's Largest Investors

Global Asset Managers

Amundi Asset Management:
http://www.amundi.com/documents/doc_download&file=5112628700767891702_5112628700761416322

AXA Investment Managers: http://www.axa-im.com/en/responsible-investment/policies-exclusions

BlackRock: http://www.blackrock.com/corporate/en-us/about-us/responsible-investment

BNY Mellon: http://www.bnymellon.com/investmentmanagement/guidelines.html

Capital Group:
https://server.capgroup.com/capgroup/action/getContent/GIG/Europe/Institutions/About_Capital/Responsible_investing/RI

Deutsche Asset Management: https://www.dws-investments.com/EN/proxy-voting.jsp

Fidelity Investments:
http://personal.fidelity.com/myfidelity/InsideFidelity/InvestExpertise/ProxyVoting/ProxyVotingOverview.shtml

Franklin Templeton Investments:
https://www.franklintempleton.com/retail/pages/generic_content/home/proxy/proxy_voting.jsf

Goldman Sachs Asset Management:
http://www.goldmansachs.com/gsam/pdfs/voting_proxy_policy.pdf

JP Morgan Asset Management:
https://www.jpmorganfunds.com/cm/Satellite?UserFriendlyURL=proxyguidelines&pagename=jpmfVanityWrapper

Northern Trust: http://www.northerninstitutionalfunds.com/resources/docs/nt_proxypolicy.pdf

PIMCO: http://investments.pimco.com/Pages/PIMCOProxyPoliciesVotingRecords.aspx

Prudential Investments: http://livermore.brand.edgar-online.com/EFX_dll/EDGARpro.dll?FetchFilingHtmlSection1?SectionID=6722960-522018-526173&SessionID=aruSHWvshMTQ6A7

State Street Global Advisors

http://www.gefunds.com/common/docs/pdf/proxy/ProxyVotingPolicies-SSgA.pdf

Vanguard: https://investor.vanguard.com/about/vanguards-proxy-voting-guidelines

Global Pension Funds

Government Pension Fund (Norway):
http://www.nbim.no/Global/Documents/Governance/Policies/NBIM%20Policy%20RI.pdf

ABP (Netherlands):
http://www.apg.nl/apgsite/pages/images/Corporate%20Governance%20Framework%202011%20ENG%20DEF_tcm124-130303.pdf

California Public Employees Retirement System (U.S.): http://www.calpers-governance.org/docs-sof/principles/2011-11-14-global-principles-of-accountable-corp-gov.pdf

Canada Pension Plan (Canada):
http://www.cppib.ca/files/Legal_Policies/2013/Proxy_Voting_Principles_and_Guidelines.pdf

Employees Provident Fund (Malaysia):
http://www.kwsp.gov.my/pv_obj_cache/pv_obj_id_617CF2816B40D623E11FF6255E0C75D54E722400/filename/BI_EPF%27S%20Corporate%20Governance%20Principles%20And%20Voting%20Guidelines.pdf

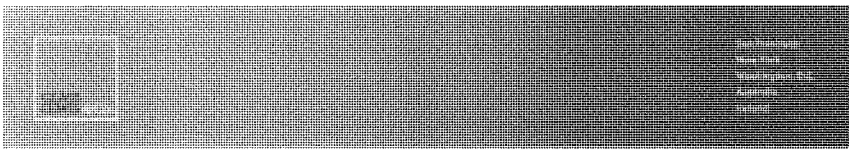
PFZW (Netherlands): http://www.pfzw.nl/about-us/Documents/responsible-investment-annual-report-2011.pdf

California State Teachers Retirement System (U.S.): http://www.calstrs.com/sites/main/files/file-attachments/corporate_governance_principles_1.pdf

New York State Common Retirement Fund (U.S.):
http://www.osc.state.ny.us/pension/proxyvotingguidelines.pdf

New York City Pension Funds (U.S.):
http://www.comptroller.nyc.gov/bureaus/bam/corp_gover_pdf/2012-Shareholder-Report.pdf

ATP (Denmark):
http://www.atp.dk/X5/wps/wcm/connect/atp/atp.com/about/omatp/investments/corporate_governance/policies/policies.htm



May 31, 2012

The Honorable Mary Schapiro
Chairman
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Dear Chairman Schapiro:

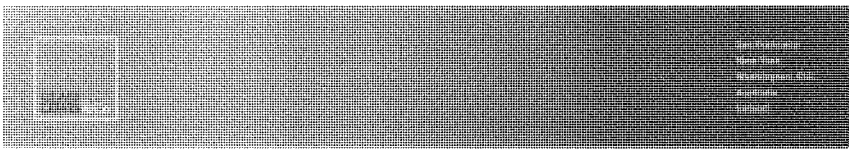
Glass, Lewis & Co. ("Glass Lewis") is a leading, independent, governance analysis and proxy voting firm, serving institutional investors globally that collectively manage more than $15 trillion in assets. With research focused on the long-term impact of proxy voting decisions, Glass Lewis provides institutional investors with the research, data and tools that help them make sound voting decisions by uncovering and assessing governance, business, legal, political and accounting risks at public companies worldwide.

We understand that on May 30, 2012, the Center for Capital Markets Competitiveness ("CCMC") of the U.S. Chamber of Commerce submitted a letter to you regarding the activities of Glass Lewis in relation to a particular proxy voting matter. The following response seeks to clarify how Glass Lewis makes its voting recommendations, and, in particular, to refute the suggestion that Glass Lewis' voting recommendations are somehow influenced by its parent's interests as an investor.

Background

Since 2007, Glass Lewis has been a wholly-owned subsidiary of Ontario Teachers' Pension Plan ("OTPP"), which manages $117 billion (Canadian) as a fiduciary on behalf of 300,000 current and retired teachers in Ontario. OTPP is subject to the Pension Benefits Act (Ontario) which sets forth fiduciary duties for all pension plan administrators in Ontario and obliges them to administer the plan and invest assets with the same prudence expected of a person dealing with another's property. The standards of conduct expected of a fiduciary are also set out in common law to which OTPP is subject. Consistent with these fiduciary responsibilities, OTPP votes according to its own proxy voting policies (which, along with OTPP's proxy votes, are publicly-available here:
http://www.otpp.com/wps/wcm/connect/otpp_en/Home/Responsible+Investing/Governance/

OTPP is the owner of Glass Lewis, not its operator; and as an owner with a long-term horizon, OTPP is committed to ensuring Glass Lewis continues as an independent advisor that puts the interests of its clients ahead of all others.



Conflict Management

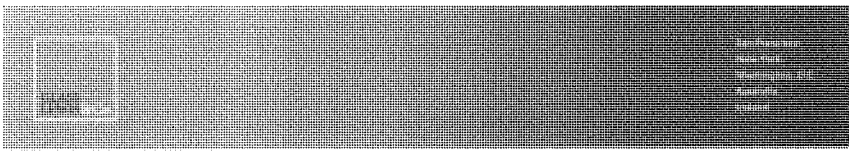
Glass Lewis prides itself on avoiding conflicts of interest to the maximum extent possible. As a result, Glass Lewis does not enter into business relationships that conflict with its mission of serving institutional participants in the capital markets with objective advice and services.

Glass Lewis takes precautions to ensure its research is objective at all times and under all circumstances. As an indirect wholly-owned subsidiary of OTPP, Glass Lewis maintains its independence and operates completely separate from OTPP. OTPP is not involved in the day-to-day management of Glass Lewis and is excluded from any involvement in how Glass Lewis formulates voting recommendations. The proxy voting and related corporate governance policies of Glass Lewis enforce that separation from OTPP.

As part of Glass Lewis' continued commitment to its customers, Glass Lewis has an independent Research Advisory Council ("Council"). The Council ensures that Glass Lewis' research consistently meets the quality standards, objectivity and independence criteria set by Glass Lewis' research team leaders. The Council, chaired by Charles A. Bowsher, former Comptroller General of the United States, and supported by Robert McCormick, Glass Lewis' Chief Policy Officer, includes the following experts in the fields of corporate governance, finance, law, management and accounting: Kevin J. Cameron, co-founder and former President of Glass, Lewis & Co.; Jesse Fried, Professor of Law at Harvard Law School; Bengt Hallqvist, Founder of the Brazilian Institute for Corporate Governance; David Nierenberg, President of Nierenberg Investment Management Company; and Ned Regan, Professor, Baruch College.

Glass Lewis does not offer consulting services to public corporations or directors. Glass Lewis is not in the business of advising public companies on their governance structures or conduct, and does not use its position as trusted advisor to institutional investors to win consulting mandates with issuers. In certain instances, Glass Lewis may provide its research reports to investment managers that may be affiliated with publicly-held companies. In such cases, however, Glass Lewis discloses any such relationship on the relevant research report. Moreover, Glass Lewis makes its research reports generally available post-publication.

Furthermore, Glass Lewis maintains additional conflict avoidance safeguards to mitigate potential conflicts. These apply when: (i) an employee of Glass Lewis or any of its subsidiaries, a member of the Council, or a member of Glass Lewis' Strategic Committee serves as an executive or director of a public company; (ii) an investment manager customer is a public company or a division of a public company; (iii) a Glass Lewis customer submits a shareholder proposal or is a dissident shareholder in a proxy contest; and (iv) when Glass Lewis provides coverage on a company in which OTPP holds a stake significant enough to have publicly disclosed its ownership in accordance with the local market's regulatory requirements; or Glass Lewis becomes aware of OTPP's disclosure to the public of its ownership stake in such company



through OTPP's published annual report or any other publicly available information disclosed by OTPP.

In each of the instances described above, Glass Lewis makes full and prominent disclosure to its customers on the cover of the relevant research report. In the case of the May 17, 2012 contested election at Canadian Pacific Railway Limited ("CP"), which features prominently in CCMC's letter, Glass Lewis provided the following disclosure on the front of its report:

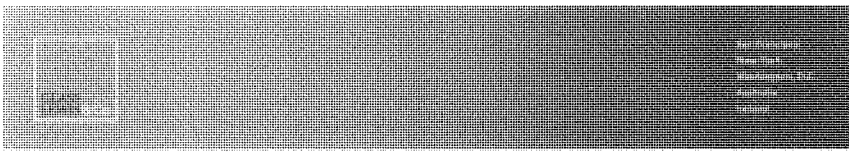
> "It is Glass Lewis' policy to make full disclosure to its customers in instances where Glass Lewis provides coverage on a company in which Ontario Teachers' Pension Plan Board ("OTPP"), Glass Lewis' ultimate parent, holds a stake significant enough to have publicly announced its ownership in accordance with the local market's regulatory requirements or Glass Lewis becomes aware of OTPP's disclosure to the public of its ownership stake in such company, through OTPP's published annual report or any other publicly available information as disclosed by OTPP.
>
> In accordance with such policy, please be advised that OTPP held an ownership stake in the Company as at December 31, 2011. OTPP is not involved in the day-to-day management of Glass Lewis. Glass Lewis operates and will continue to operate as an independent company separate from OTPP. The proxy voting and related corporate governance policies of Glass Lewis are separate from OTPP. OTPP is not a member of Glass Lewis' Research Advisory Council.
>
> For a complete copy of Glass Lewis' Conflict of Interest Statement, please visit http://www.glasslewis.com/company/disclosure.php."

A copy of the complete research report for CP is included with this letter.

Research Process

Glass Lewis research professionals analyze public company filings, specifically proxy statements and financial statements, as well as multiple external original research sources to evaluate board effectiveness and company risk profiles.

Glass Lewis strongly believes its analysis, research and recommendations should be based on publicly available information and encourages companies to provide comprehensive and clear disclosure about the relevant issues for consideration by shareholders. For this reason, Glass Lewis often engages in discussions with companies outside the proxy season, but generally does not engage in discussions with companies during the proxy solicitation period. In the case of contested meetings, Glass Lewis will occasionally engage in separate discussions with both sides, usually in the form of a Proxy Talk conference call. In the case of CP, Glass Lewis met with



both representatives of the Company and the dissident shareholder. All of these discussions were confined to a review of materials already in the public domain.

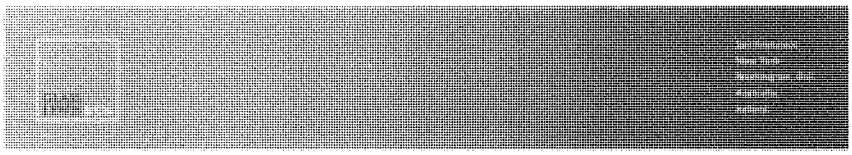
In its May 30 letter, CCMC asserts that the timing of the Glass Lewis report publication, subsequent to the announcement by OTPP of its vote decisions on the CP meeting, is indicative that the Glass Lewis recommendation was somehow influenced by OTPP's vote decision. However, you should know that OTPP, as a matter of policy, publishes its voting intentions as soon as OTPP has voted, in advance of a shareholder meeting.

For its part, Glass Lewis normally publishes its reports on annual general meetings at U.S. and Canadian companies about three weeks prior to meeting date. In cases where OTPP is a shareholder, this usually would precede OTPP's announcement of its voting intentions. However, there is no effort on Glass Lewis' or OTPP's part to coordinate the timing of these events, and any such coordination would in fact contravene the separation enforced by Glass Lewis' policies. When there is a proxy contest, where the situation is more fluid due to potential negotiations and additional disclosure by both parties, Glass Lewis often publishes its reports close to the meeting date as it attempts to balance the need to give clients sufficient time to review and digest our analysis with the need to ensure that clients have the complete, up-to-date analysis to support their informed decision-making. Often companies make concessions in the face of potentially losing a proxy contest as the meeting date approaches, which was the case at CP. The date of publication of Glass Lewis' report on CP also was affected by the timing of the previously mentioned meetings with the dissident and the Company and the need to complete the analysis after the conclusion of those meetings.

Glass Lewis Recommendations Independent From OTPP

In CCMC's May 30 letter, CCMC cited an article that appeared in the *Wall Street Journal Online* regarding Glass Lewis' voting recommendations in regards to CP. In that very article, the author noted, contrary to CCMC's assertions, that "Ontario Teachers owns Glass Lewis, but they make corporate governance decisions independent of each other." In fact, that is precisely what happened in this case, where OTPP voted against all of the incumbent directors, whereas Glass Lewis recommended supporting seven of the Company nominees.

There have been numerous other instances where Glass Lewis recommended that its clients vote in a manner that differed from OTPP's votes. Notably, in 2011 Glass Lewis recommended in favor of the offer by the London Stock Exchange (LSE: LSE) to purchase to the TMX Group Inc. (TSX: X), which owns and operates the Toronto Stock Exchange and TSX Venture Exchange, whereas OTPP and other Canadian investors were prominent and public opponents of the transaction, before and after the publication of Glass Lewis' analysis. This year Glass Lewis recommended against two directors at Magna International Inc. (TSX: MG), whereas OTPP voted against all the directors that had been at the company since 2010. And, in 2010, OTPP



publicly came out against the chairman and deputy chairman at Vodafone (LSE: VOD), both of whom Glass Lewis supported.

Transparency

Glass Lewis' public website (www.glasslewis.com) features an Issuer Engagement Portal, through which issuers can download substantial information regarding Glass Lewis' policies and procedures, including details on the approaches used for the analysis of director elections, compensation plans, mergers & acquisitions and contested meetings, among other issues. This information is available by clicking on "Issuers" in the top navigation. Glass Lewis' Conflict of Interest Statement is also available on the website at http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/ and Conflict Avoidance Procedures are available upon request.

As outlined in Glass Lewis' comment letter regarding the S.E.C. Concept Release on the U.S. Proxy System issued in 2010 (File Number S7-14-10) and reiterated here, Glass Lewis maintains robust conflict avoidance and disclosure policies. Indeed, since the issuance of the release, Glass Lewis has dramatically enhanced its transparency with the development of the Issuer Engagement Portal. Furthermore, Glass Lewis is accountable to its clients, who use its research to make informed proxy voting decisions and have the option to use other provider(s) if they perceive the research to be conflicted or flawed.

Glass Lewis appreciates the opportunity to respond to the CCMC letter and is confident that an objective consideration of this matter demonstrates that Glass Lewis makes proxy voting recommendations free from conflicts of interest and in an open and transparent manner.

Sincerely,

/s/

Katherine H. Rabin
Chief Executive Officer

cc: Elisse B. Walter, Commissioner, Securities and Exchange Commission
Luis A. Aguilar, Commissioner, Securities and Exchange Commission
Troy A. Paredes, Commissioner, Securities and Exchange Commission
Daniel M. Gallagher, Commissioner, Securities and Exchange Commission

Enc.