

February 3, 2011

Office of Regulations and Interpretations  
Employee Benefits Security Administration  
Attn: Definition of Fiduciary Proposed Rule  
Room N-5655  
U.S. Department of Labor  
200 Constitution Avenue, NW  
Washington, DC 20210

RE: Comments on Definition of Fiduciary Proposed Rule

Dear Sir or Madam:

The Center On Executive Compensation (the "Center") is pleased to submit comments regarding the Department of Labor's (the "Department") proposed regulation ("Proposed Regulation") under the Employee Retirement Income Security Act of 1974, as amended ("ERISA") that will redefine the term fiduciary under section 3(21) of ERISA and section 4975(e) of the Internal Revenue Code of 1986, as amended (the "Code"). We appreciate the opportunity to provide comments.

The Center is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 300 large companies, and the Center's more than 70 Subscribing Companies are HR Policy members that represent a broad cross-section of industries. Because senior human resource officers play a unique role in serving on or supporting ERISA plan committees and also in advising compensation committees on compensation and related governance issues, we believe the Center's views can be particularly helpful in understanding the implications of the Proposed Regulations on the proxy voting process for ERISA plans and other institutional investors.

This comment letter narrowly focuses on the issues raised in the Department's Proposed Regulation with respect to the fiduciary status of proxy advisory firms. The Center does not endorse the broad definition of fiduciary in the Proposed Regulation. While the Center supports the intent behind the Proposed Regulation to protect ERISA plan participants, we believe that the far-reaching effects of the Proposed Regulation would have unintended consequences, including increasing plan costs. At the same time, the Center is very concerned that proxy advisory firms are insufficiently regulated and that the current lack of oversight of proxy advisory firms has permitted alarming conflicts of interest and material inaccuracies in the reports provided to institutional investors, including ERISA plans, and that these practices also harm plans and participants.

The Center therefore urges the Department not to broadly expand the definition of fiduciary in the Proposed Regulation, and instead **undertake a comprehensive review of proxy advisory firms**, as outlined in our comments below.

Our detailed comments on these issues and request to testify at the hearing on the Proposed Regulation follow. We would also be pleased to meet with the Department separately to discuss the proxy voting process as it affects employee benefit plans.

## **I. Proxy Advisory Firms**

### **A. Background**

Proxy voting recommendations were introduced by proxy advisory firms in the mid-1980s to satisfy a demand that had grown in response to dramatic changes in the nature of share ownership. Institutional investors now own 76.4 percent of the 1,000 largest American corporations, a dramatic increase from 1987, when they held less than 47 percent, while over this period retail share ownership has declined. At the same time, the volume of proxy votes has grown tremendously as the Securities and Exchange Commission (the "SEC") has expanded the categories of subjects that shareholder proposals could address. Together, these factors have meant that institutional investors, including many ERISA plans, which hold thousands of equity securities in their portfolios, are required to vote exponentially more proxy votes.

Retirement plan fiduciaries, bound by ERISA's fiduciary duties, must vote proxies solely in the best interests of their plan participants and beneficiaries. To properly exercise their duties, institutional investors must have conducted due diligence and become informed on the topics on which they are voting. In order to discharge their responsibilities, institutional investors have sought outside assistance in researching and analyzing the proxy statements of the companies in which they have a stake and, as a result, have purchased analyses and voting recommendations from proxy advisory firms.

Given the dramatic increase in the volume of proxy votes, institutional investors have increasingly relied on the recommendations of proxy advisors in determining their proxy votes. Most industry observers agree that proxy advisors have a significant influence on vote outcomes. Delaware Court of Chancery Vice Chancellor Leo E. Strine, Jr. commented 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."<sup>1</sup> Academic research has shown that if ISS, the dominant proxy advisory firm, issues a negative recommendation on a management proposal, it can reduce

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<sup>1</sup> 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](http://lsr.nellco.org/harvard_olin/541).

the support of institutional investors by up to 20 percent thereby setting up ISS as the *de facto* pay and governance police for American corporations.<sup>2</sup>

## **B. Current Regulatory Environment**

Given the tremendous influence that proxy advisory firms wield, one would think that they are a heavily regulated industry. In fact, however, proxy advisory firms are overseen by a patchwork of regulation and, where regulation exists, it is unclear that it is effective.

The Investment Advisers Act of 1940 (the "Act") is the principal regulatory scheme that would apply to proxy advisory firms. The SEC has stated that it considers proxy advisory firms to be investment advisers "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."<sup>3</sup> Although the SEC has asserted that proxy advisory firms meet the definition of advisers under the Act, proxy advisory firms may elect whether to register under the Act. Additionally, the Act contains a prohibition against registering if the firm has less than \$25 million in assets under management.<sup>4</sup> This prohibition applies to proxy advisory firms since they do not manage client assets. Moreover, 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. Currently only one of the two predominant proxy advisory firms, ISS, is registered with the SEC as an investment adviser using the pension consultant exemption.<sup>5</sup>

There are some provisions of the Act that apply to proxy advisory firms regardless of whether they are registered with the SEC as an investment adviser. The provision of greatest importance prohibits a proxy advisory firm from engaging in "any transaction, practice or course of business which operates as a fraud or deceit on any client or prospective client."<sup>6</sup>

This prohibition against fraud or deceit governing the proxy advisory industry is one relating to fiduciary duties. The SEC has stated that a proxy advisory firm owes fiduciary duties to its clients, which entails a "duty of care requiring [the proxy advisory firm] to make a reasonable investigation to determine that it is not basing its recommendations on materially inaccurate or incomplete information."<sup>7</sup> The impact of this regulation has led many to question whether these duties serve as any real restraint on the behavior of the proxy advisory industry. As outlined below, the business model and ownership structure of the proxy advisory industry are riddled

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<sup>2</sup> Jennifer E. Bethel & Stuart L. Gillan, *The Impact of the Institutional and Regulatory Environment on Shareholder Voting*, FINANCIAL MANAGEMENT 29, 34 (Winter 2002).

<sup>3</sup> Sec. Exch. Comm'n, Concept Release on the U.S. Proxy System, Release No. 34-62493, 110 (July 14, 2010).

<sup>4</sup> National Securities Markets Improvements Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).

<sup>5</sup> A third proxy advisory firm, Proxy Governance, Inc., ceased operations as of December 31, 2010, and the second largest proxy advisory firm, Glass Lewis, which is not registered with the SEC, assumed the contracts of the firm's clients.

<sup>6</sup> Investment Advisers Act of 1940 § 206-2, 15 U.S.C. § 80b-6(2).

<sup>7</sup> Sec. Exch. Comm'n, Concept Release on the U.S. Proxy System, Release No. 34-62493, 119 (July 14, 2010).

with conflicts of interest. There are conflicts between the clients that proxy advisory firms serve and there is seemingly no obligation to ensure the accuracy of the analyses and voting recommendations that those firms offer to their clients.

### **C. Problems with Current Practices**

The current practices of proxy advisory firms are riddled with several problems. These include conflicts of with respect to clients and ownership, and material inaccuracies that could impact the outcome of proxy votes.

#### **i. Conflicts of Interest**

The most pressing problem with the proxy advisory industry is the existence of significant conflicts of interest. Proxy advisors are afforded considerable deference by the SEC because they are considered to be providing "independent" opinions and voting recommendations to their institutional clients. Yet, this independence is only superficial since there are conflicts of interest in the services that are provided and how these firms are structured. These conflicts of interest affect the integrity of the proxy advisors' analyses and voting recommendations.

Proxy advisory firms research and review the required proxy disclosures filed by public companies in order to make recommendations to their clients on how to vote. This service, which is intended to be "independent," allows institutional investors to more efficiently discharge their voting responsibilities as it is extremely difficult for institutional investors to adequately conduct the research necessary to make educated decisions to vote proxies for the hundreds of companies contained in their portfolios.

ISS, the largest and most influential proxy advisory firm, engages in the worst form of conflict by providing so-called independent analyses of company practices while also offering consulting services to the same companies. The U.S. Government Accountability Office ("GAO") has studied this issue and has noted 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."<sup>8</sup> This vicious cycle is routinely criticized by both institutional investors and corporations, because ISS determinations and their related consulting shapes what is considered to be best practice, even if that practice may not be in the best interest of the companies or their shareholders. Graef Crystal, a former prominent compensation consultant turned author and compensation critic, has noted: "[ISS has] 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."<sup>9</sup> The Center believes it is impossible

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<sup>8</sup> 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).

<sup>9</sup> Wayne Leslie, *Have Shareholder Activists Lost Their Edge?*, N.Y. TIMES, Jan. 30 1994, at C7.

for a proxy advisory firm to offer both of these services and meet their fiduciary obligations under the Act to institutional investors.

## **ii. Ownership Structure Conflicts of Interest**

There are conflicts of interest in the ownership structures at all proxy advisory firms. For example, the second largest proxy advisory firm, Glass, Lewis & Co., is owned by the Ontario Teachers' Pension Plan, which invests in companies on which Glass Lewis provides proxy voting recommendations. ISS is owned by MSCI, Inc., which provides other financial services to both corporate issuers and institutional investors.

These ownership structures certainly present situations where the interests of the parent company's clients diverge from that of the proxy advisory firm's clients. Moreover, when a parent company owns a significant stake in or has an ongoing business relationship with the companies on which the firm is making proxy voting recommendations, there is a cause for concern that the recommendations cannot truly be independent. It is reasonable to assume that the parent company would favor or lean on the proxy advisory firm to favor the public companies that they own or with whom they have a business relationship. Proxy advisory firms are not currently required to disclose these conflicts of interest; therefore, institutional investors are incapable of making informed decisions whether there is an impermissible conflict of interest or if the proxy advisor's recommendation or analysis has been compromised.

## **iii. Material Inaccuracies**

The SEC has asserted that a proxy advisory firm owes fiduciary duties to its clients, holding a proxy advisory firm to 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."<sup>10</sup> In a 2010 survey of HR Policy Association members and Center On Executive Compensation Subscribers, 53 percent of respondents 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. The most common inaccuracies related to improper use of peer groups or peer group data in determining whether executive compensation levels were appropriate, erroneous analysis of long-term incentive plans and discussions of provisions that were no longer in effect. Companies are extremely concerned that these inaccuracies lead to voting decisions by institutional investors that will adversely impact the company and ultimately shareholders.

Industry cost pressures are most likely the cause of the material inaccuracy problem. The size of proxy disclosures and the volume of data and information that must be analyzed have grown exponentially in recent years as a result of changes in SEC proxy disclosure rules. Under pressure to increase profitability, some proxy advisory firms have resorted to outsourcing "data

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<sup>10</sup> Sec. Exch. Comm'n , Concept Release on the U.S. Proxy System, Release No. 34-62493, 119 (July 14, 2010).

mining" and research functions to low cost labor countries. ISS, for example, has established a branch in the Philippines. Other proxy advisory firms hire third-party contract firms to procure and extract proxy statement information. For in-house work, a considerable amount of data collection is handled by seasonal, temporary employees. The fact that a substantial share of proxy analysis and voting recommendations is being done by foreign outsourced labor and temporary employees with limited business or proxy experience is extremely troubling and may serve as a partial explanation of why material inaccuracies have become such a problem.

Moreover, proxy advisory firms generally do not give most companies an opportunity to review their draft reports prior to the issuance of a final report. When a proxy advisory firm does allow a company to review a draft report, the company is given an unreasonably short period of time for review – typically, one to two days – to point out inaccuracies and suggest corrections before the final report is issued. Even then, there is no established process for making those corrections and no opportunity for an institutional investor to know of a disagreement between the proxy advisory firm and the company.

Inaccurate information in proxy advisor reports is capable of causing significant harm to companies and their investors. The recommendations of proxy advisors, which are heavily relied upon by institutional investors, can result in the failure of a compensation plan to be approved or votes against boards of directors. When these recommendations are made based on inaccurate information, both companies and shareholders alike are damaged. Moreover, companies often adjust their policies based on the actions of proxy advisory firms in order to ensure approval of plans and directors. Because these analyses and voting recommendations carry such significant influence, it is critical that they be based on accurate information. Additional regulation and oversight is necessary to ensure significant inaccuracies do not occur.

## **II. ERISA Fiduciary Analysis**

### **A. Background**

Section 3(21) of ERISA provides that a person is a fiduciary with respect to a plan to the extent (i) he exercises any discretionary authority or discretionary control respecting management of such plan or exercises any authority or control respecting management or disposition of its assets, (ii) he renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (iii) he has any discretionary authority or discretionary responsibility in the administration of such plan.

The Department has historically taken the view that the fiduciary act of managing plan assets includes exercising the legal rights that accompany ownership of securities and other property. Under ERISA, those rights may be exercised by the plan's trustee (including at the direction of a named fiduciary), or by an "investment manager" who has been properly appointed by the plan's named fiduciary. Specifically, section 402(c)(3) of ERISA provides that a named fiduciary may appoint an investment manager to manage plan assets. Section 3(38) of ERISA defines an

"investment manager" as (A) any fiduciary who has the power to manage, acquire or dispose of any plan asset, (B) who is (i) a registered investment advisor under the Investment Advisers Act of 1940 (or a state law in certain circumstances), (ii) a bank, or (iii) an insurance company; and (C) who has acknowledged in writing that he is a fiduciary with respect to the plan. In connection with proxy voting responsibilities, the Department has opined that an investment manager is not relieved of its own responsibilities and related liabilities merely because it followed the direction of some other person, or delegated its voting responsibility to some other person.<sup>11</sup>

The Center believes that a proxy advisory firm may properly be viewed as a fiduciary to the extent that the proxy advisor effectively exercises discretion over the proxy decision.<sup>12</sup> This would include, for instance, where the proxy advisor is acting as an "investment manager" and where a properly appointed investment manager has delegated its proxy voting responsibilities to the proxy advisor. In this regard, the Center also believes that an investment manager who merely follows the direction of such adviser would continue to be liable for the proxy voting decision.<sup>13</sup>

Although the Center agrees that proxy advisors may, in some circumstances properly be viewed as fiduciaries, the Center does not endorse the broad redefinition of fiduciary in the Proposed Regulation. The Center is concerned that the Proposed Regulation could significantly expand the circumstances under which numerous persons supporting the management of plan assets, but not exercising discretion over fiduciary decisions, would be deemed to be fiduciaries, and thus significantly increase plan costs and harm plan participants, fiduciaries, and sponsors.

## **B. Proposed Regulation**

Under the Proposed Regulation, a person who "provides advice or makes recommendations as to the management of securities or other property" of an ERISA plan may be an ERISA fiduciary. The Preamble to the Proposed Rule provides that "[t]his would include, for instance, advice and recommendations as to the exercise of rights appurtenant to shares of stock (e.g., voting proxies)."<sup>14</sup>

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<sup>11</sup> Department of Labor's letter to the Chairman of the Retirement Board of Avon Products, Inc. (February 23, 1988); Department of Labor's letter to Robert A.G. Monks of Institutional Shareholder Services, Inc. (January 23, 1990); DOL Interpretive Bulletins 94-2 and 2008-2.

<sup>12</sup> "While the ordinary functions of consultants or advisers to employee benefit plans (other than investment advisers) may not be considered as fiduciary functions, it must be recognized that there will be situations where such consultants and advisers may because of their special expertise, in effect, be exercising discretionary authority or control with respect to the management or administration of such plan or some authority or control regarding its assets." H.R. Rep. No. 93-1280, at 323 (1974) (Conf. Rep.).

<sup>13</sup> Department of Labor's letter to the Chairman of the Retirement Board of Avon Products, Inc. (February 23, 1988); Department of Labor's letter to Robert A.G. Monks of Institutional Shareholder Services, Inc. (January 23, 1990); DOL Interpretive Bulletins 94-2 and 2008-2.

<sup>14</sup> Dep't of Labor, Preamble to Definition of the Term "Fiduciary," 75 Fed. Reg. 65,263 (proposed Oct. 22, 2010) (to be codified at 29 C.F.R. § 2510).

The Center agrees with the Department's longstanding view that voting of proxies is an important fiduciary activity. Moreover, the Center strongly believes that retirement plans and other institutional investors responsible for voting proxies need to have access to accurate, unbiased information, provided free from conflicts of interest.

The Center is, however, concerned that the Proposed Regulation could potentially brand as fiduciaries numerous individuals and entities that provide basic services to plans that have not traditionally been considered fiduciary in nature. In particular, by expanding the category of investment advice to include any "advice or . . . recommendations as to the management of securities or other property," the Proposed Regulation could conceivably sweep in as a fiduciary any person who provides input to a plan, a plan fiduciary, or a plan participant or beneficiary regarding plan investments or plan assets.

It is the view of the Center that a person who merely provides information that supports a fiduciary decision relating to the management of plan assets should not, without more, be deemed a fiduciary adviser. Otherwise, we fear that a multitude of other activities undertaken to support plan investment activities could also be deemed fiduciary advice. For example, plan sponsor employees supporting a fiduciary investment committee's investment decision could, under the Proposed Regulation, be deemed to be providing investment advice. We do not think that this result will benefit plans, participants, fiduciaries, or plan sponsors.

In the case of proxy advisory firms, the Proposed Regulation fails to recognize that such firms offer a variety of services and play a number of different roles with respect to ERISA plans and other institutional investors. For example, a proxy advisory firm may provide services based on the firm's base proxy voting policy or based on a customized policy provided by the institutional investor. A proxy advisory firm also may simply provide specific information with respect to a particular vote. Moreover, one of the two predominant proxy advisory firms, ISS, is registered with the SEC as an investment adviser while the other, Glass Lewis, is not. Due to the variety of roles and services offered by proxy advisory firms, the Center believes that the Department's approach in the Proposed Regulation unevenly impacts proxy advisory firms.

In sum, the Center is concerned that the Proposed Regulation could significantly increase plan costs and harm plans, participants, fiduciaries, and plan sponsors, and would not provide an even playing field for proxy advisors. Instead, as discussed in greater detail below, the Center requests that the Department carefully review the activities of proxy advisory firms to determine the appropriate course of action and oversight as well as provide much needed guidance to plan fiduciaries with respect to how to evaluate the information provided by proxy firms.

### **C. Need for Comprehensive Review**

Ideally, institutional investors, consistent with their fiduciary obligation to vote proxies, would have adequate information to ensure that the recommendations made by proxy advisors and the votes that are based on those recommendations are consistent with the creation of long-term shareholder value. As a consequence of many institutions having a very large number of



security holdings, however, coupled with the ever-larger volume of material that issuers are required to disclose in proxy statements, it is perhaps somewhat naïve to expect that institutional investors will rely less heavily on proxy advisory firms.

The Center believes that any proxy advisory firm that effectively exercises discretion over a proxy decision should be deemed a fiduciary. Further, we believe that there are circumstances in which proxy advisory firms currently are exercising discretion over proxy decisions. In this regard, the Center requests that the Department investigate whether the practices of proxy advisory firms should be deemed, under existing regulations, to constitute discretion over proxy voting decisions.

In cases where a proxy advisory firm is not exercising discretion, the Center believes that such firms play an important role that can help institutional investors fulfill their fiduciary duty to vote their proxies in their clients' best interest, provided the information provided by the proxy advisors is reliable. However, without a more rigorous regulatory and oversight process, we are concerned that the integrity of the proxy system may be undermined by growing evidence of material inaccuracies and conflicts of interest by proxy advisors that could seriously impact the proxy voting process.

### **III. Recommendations for Greater Regulation of the Proxy Advisory Industry**

The Center believes that the influence of the proxy advisory firm industry requires greater oversight by the Federal regulatory agencies having authority over them. This includes regulation by the SEC under the Act and oversight and investigation by the Department.

#### **A. A Call for Greater Regulation/ Oversight**

The current regulatory framework is largely responsible for the influence that proxy advisors wield over institutional investor voting. The Center believes that the most effective approach for mitigating and addressing the issues surrounding the conflicts of interest and inaccuracies with the proxy advisory industry, among other issues, requires a series of regulatory and market reforms.

The Center has asked the SEC to impose greater and more consistent regulations across proxy advisory firms – and will continue to advocate to the SEC that such regulations not be optional. The proxy advisory industry needs uniform standards that address conflicts of interest and inaccuracies that undermine the very services they provide. The Center believes that enlisting the Department in this regulatory effort can only help in ridding this service industry to ERISA plans of serious problems, which will ultimately benefit plan participants.

**B. Request for Department of Labor Investigation into Proxy Advisory Firm Practices**

In order to ensure that plan fiduciaries have accurate and reliable information upon which to base proxy voting decisions, the Center requests that the Department undertake a comprehensive review and investigation of proxy advisory firm practices.

The most serious issue facing the proxy advisory firm industry is at the largest, most influential proxy advisory firm, ISS. ISS currently provides consulting services to corporate issuers while simultaneously providing "independent" analyses to institutional investors on those same companies. The Center believes it would be impossible to provide both of these services and still meet their fiduciary obligations to the institutional investors. For this reason, there should be a ban on proxy advisory firms, or their affiliates from this practice. Until the change is effective, the Department 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.

Proxy advisory firms should also be required to make the financial relationships that underpin the most controversial aspects of the proxy advisory industry transparent to institutional investors. Specifically, the Center recommends that proxy advisory firms be required 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 accessible to any investor who is relying on the recommendation in the report.

Furthermore, proxy advisory firms should be required to disclose their analytic processes, methodologies and models utilized to derive their voting recommendations. Although ISS currently provides some of this disclosure, it is still not sufficiently transparent. Glass, Lewis & Co., its major competitor, provides virtually no disclosure as to processes and methodologies. Additional disclosure would allow issuers and institutional investors to effectively assess the merits and weaknesses of such models and to provide feedback to proxy advisory firms on these models.

**C. Additional Information**

For further information on this topic, we have attached a copy of the Center's white paper, *A Call for Change in the Proxy Advisory Industry Status Quo*, as well as policy briefs that summarize the major issues with the proxy advisory industry. We hope to utilize this opportunity to start a dialogue on how best to regulate an industry that wields tremendous power but is currently operating without sufficient oversight.

**IV. Conclusion**

Rather than finalize the Proposed Regulation, the Center strongly urges the Department to undertake a comprehensive review of proxy advisory firms and work with the SEC and other agencies that also are investigating the regulation of proxy advisory firms, to identify areas where focused and comprehensive regulation will provide real benefits to the users of proxy advisory services, including ERISA plans. The Center would be happy to meet with the Department and to provide information on our concerns regarding the significant influence over institutional investors that proxy advisory firms exercise, and the fact that there are serious conflicts of interest issues in the proxy advisory industry.

**V. Request to Testify at Hearing**

The Center requests the opportunity to testify at the hearing on the Proposed Regulation and expects to file a separate outline of testimony in the near future.

\* \* \* \*

The Center On Executive Compensation appreciates this opportunity to provide comments on the Definition of Fiduciary Proposed Rule and the specific role of proxy advisory firms. If you have any questions about these comments, please contact me at [tbartl@execcomp.org](mailto:tbartl@execcomp.org).

Sincerely,



Timothy J. Bartl  
Senior Vice President and General Counsel

Attachment



# **A Call for Change in the Proxy Advisory Industry Status Quo**

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## **The Case for Greater Accountability and Oversight**

January 2011  
*c11-07b*

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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.



## 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,<sup>1</sup> and a second, Glass, Lewis & Co. controls approximately 37% of the market.<sup>2</sup> 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,<sup>3</sup> 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.<sup>4</sup>

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.<sup>5</sup> 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.<sup>6</sup>
- 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.”<sup>7</sup>

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.”<sup>8</sup>

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.”<sup>9</sup> 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.<sup>10</sup>

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.”<sup>11</sup>

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.”<sup>12</sup> 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.<sup>13</sup> 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

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.<sup>14</sup> 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.<sup>15</sup> 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.<sup>16</sup> 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.<sup>17</sup>

**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.<sup>18</sup> 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

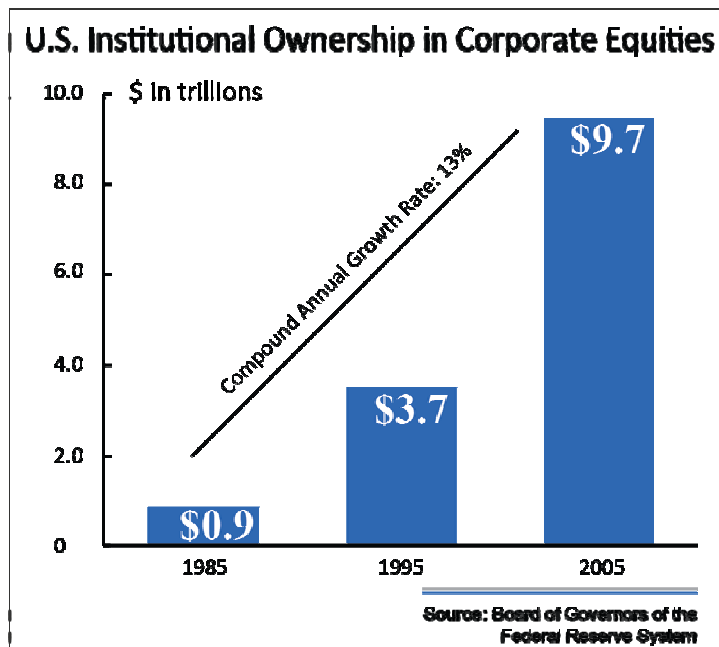
2007, levels of institutional stock ownership of the 1,000 largest corporations in the U.S. reached an all-time high of 76.4 percent, according to the Conference Board, up from an average of 61.4 percent in 2000 and 46.6 percent in 1987.<sup>19</sup>

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.<sup>20</sup> 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, trustee 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.<sup>21</sup>

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.<sup>22</sup>

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.<sup>23</sup>

### **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.<sup>24</sup>

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.<sup>25</sup>

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.<sup>26</sup> 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.<sup>27</sup>

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.”<sup>28</sup> 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.<sup>29</sup>

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:<sup>30</sup>

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.<sup>31</sup>

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.<sup>32</sup> 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.<sup>33</sup> 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.<sup>34</sup> 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."<sup>35</sup>

## **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.<sup>36</sup> 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.”<sup>37</sup> 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. . . .”<sup>38</sup>

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.<sup>39</sup> 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.<sup>40</sup>

**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.<sup>41</sup> Another academic study published by the European Corporate Governance Institute found that ISS recommendations were significantly related to the passage of management proposals.<sup>42</sup>

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.<sup>43</sup> 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."<sup>44</sup> 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.<sup>45</sup> 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.<sup>46</sup> 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.<sup>47</sup>

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.<sup>48</sup> 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.<sup>49</sup> 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.<sup>50</sup> 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.<sup>51</sup>

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.<sup>52</sup>

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.<sup>53</sup> 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.<sup>54</sup> 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.<sup>55</sup>

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.<sup>56</sup> 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.<sup>57</sup> 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.<sup>58</sup>

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.<sup>59</sup> 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.<sup>60</sup>

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 10<sup>th</sup> 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.<sup>61</sup>



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.<sup>62</sup>

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.<sup>63</sup> 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.<sup>64</sup> 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.<sup>65</sup> The SEC also amended Rule 14a-8 to allow shareholder proposals seeking bylaw amendments relating to proxy access.<sup>66</sup> 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,<sup>67</sup> 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.<sup>68</sup>

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.<sup>69</sup> 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.<sup>70</sup>

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.<sup>71</sup>

**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**

|  |
|--|
| <b>1985</b> – ISS founded by Robert A.G. Monks   |
| <b>June 1995</b> – ISS is acquired by the CDA unit of Thomson Financial Services, a unit of The Thomson Corp.  |
| <b>1997</b> – ISS acquires Proxy Voter Services, a proxy advisor to union funds  |
| <b>August 2001</b> – 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 |
| <b>May 2005</b> – ISS completes acquisition of the corporate governance unit of Brussels-based Deminor International for \$1.0 million   |
| <b>June 2005</b> – ISS completes acquisition of Proxy Australia Pty Ltd., Australia’s leading governance research firm for \$0.7 million   |
| <b>August 2005</b> – ISS completes acquisition of IRRC, a leading U.S. proxy research firm for \$14.3 million  |
| <b>January 2007</b> – RiskMetrics completes acquisition of ISS for \$542.6 million in cash and stock   |
| <b>July 2007</b> – RiskMetrics announces definitive agreement to acquire the Center for Financial Research and Analysis (CFRA), a leading financial forensic analysis firm, for \$61.4 million   |
| <b>January 2008</b> – RiskMetrics prices IPO   |
| <b>February 2009</b> – RiskMetrics announces acquisition of Innovest Strategic Value Advisers, an environmental investing research firm for \$14.3 million in cash   |
| <b>November 2009</b> – RiskMetrics completes acquisition of KLD Research and Analytics, a leading ES&G research firm for \$9.9 million in cash   |
| <b>June 2010</b> – 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.<sup>72</sup> 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.<sup>73</sup> 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.”<sup>74</sup> 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.<sup>75</sup> 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.”<sup>76</sup> 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.<sup>77</sup> 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.<sup>78</sup>

**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.<sup>79</sup> 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.<sup>80</sup>

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.<sup>81</sup>

## **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.<sup>82</sup>

**History and Ownership.** Gregory P. Taxin, Lawrence M. Howell, and Kevin J. Cameron, co-founded Glass, Lewis & Co. in 2003.<sup>83</sup> 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.<sup>84</sup>

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.)<sup>85</sup> 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.<sup>86</sup> 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.<sup>87</sup>

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."<sup>88</sup> 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."<sup>89</sup>

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.<sup>90</sup>

**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."<sup>91</sup> 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."<sup>92</sup> 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.<sup>93</sup>

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.<sup>94</sup> FISCOP LLC is, in turn, majority-owned by Broderick Management LLC, which is owned by billionaire investor, Gordon P. Getty.<sup>95</sup>

**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."<sup>96</sup> 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."<sup>97</sup> The firm says it offers "a comprehensive range of flexible, Web-based proxy advisory, voting and reporting services."<sup>98</sup> 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.<sup>99</sup> 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.<sup>100</sup> 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."<sup>101</sup>

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.<sup>102</sup> 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."<sup>103</sup> 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.<sup>104</sup>

#### **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.<sup>105</sup>

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.<sup>106</sup> 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.<sup>107</sup>

**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.<sup>108</sup>

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.<sup>109</sup> 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."<sup>110</sup> 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-trusted 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.<sup>111</sup> 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-trusted 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.”<sup>112</sup> 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.<sup>113</sup>

**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.<sup>114</sup> 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.<sup>115</sup>

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.<sup>116</sup>

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 be at 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 pertains 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.<sup>117</sup>

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.<sup>118</sup> 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.<sup>119</sup>

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."<sup>120</sup> 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.<sup>121</sup>

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."<sup>122</sup> "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."<sup>123</sup> 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."<sup>124</sup> 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.<sup>125</sup>

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.<sup>126</sup>

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.<sup>127</sup>

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.<sup>128</sup> “When these firms go public, there’s real potential for a conflict of interest.”<sup>129</sup>

## **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.”<sup>130</sup> 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.”<sup>131</sup> 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.”<sup>132</sup>

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.”<sup>133</sup> 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.<sup>134</sup> 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.”<sup>135</sup> 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.<sup>136</sup>

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.<sup>137</sup>

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.<sup>138</sup> 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.<sup>139</sup> 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.”<sup>140</sup> 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.<sup>141</sup> 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.<sup>142</sup> 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.<sup>143</sup>

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.<sup>144</sup>

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.”<sup>145</sup> 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.<sup>146</sup>

## **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.<sup>147</sup>

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."<sup>148</sup> The firm is also registered as an investment adviser and files a Form ADV statement that provides some information about ownership and potential conflicts.<sup>149</sup>

## **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.”<sup>150</sup>

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.”<sup>151</sup>

A 2009 study on the credit ratings agencies by the Congressional Research Service listed a number of perceived reasons for the industry’s failings.<sup>152</sup> 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.<sup>153</sup>

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.<sup>154</sup> 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.<sup>155</sup>

**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.<sup>156</sup>

**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%).<sup>157</sup>

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.<sup>158</sup>

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.<sup>159</sup>

**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.

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- 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.

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- 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.

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- 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.

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- 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.

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- 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.

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- Glass Lewis did not calculate "pay for performance" correctly which led to a "D" compensation rating.

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- 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.<sup>160</sup>

## **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 section 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.<sup>161</sup> 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."<sup>162</sup> The SEC has further stated that, as investment advisers, "proxy advisory firms owe fiduciary duties to their advisory clients."<sup>163</sup>

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.<sup>164</sup> 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."<sup>165</sup>

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.<sup>166</sup> 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.<sup>167</sup> 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.<sup>168</sup>

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.”<sup>169</sup> 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 advisers, including the registered proxy advisory firms.<sup>170</sup> 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.”<sup>171</sup>

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.<sup>172</sup>

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.<sup>173</sup> 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.<sup>174</sup>

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.<sup>175</sup>

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.<sup>176</sup>

### **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.”<sup>177</sup> 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.”<sup>178</sup>

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).<sup>179</sup> 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.<sup>180</sup> 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) . . .”<sup>181</sup> 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.<sup>182</sup>

## **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.”<sup>183</sup> 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,”<sup>184</sup> 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.”<sup>185</sup> 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.”<sup>186</sup> 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.<sup>187</sup>

The parallels to prior meltdowns and the impact of the PCAOB make this option worth considering.

**TABLE 4:**

| <b>Regulatory Requirement for Credit Ratings Agencies in Dodd-Frank Act</b>   | <b>Similar Potential Regulatory Requirement for Proxy Advisors</b>   |
|---|--|
| <ul style="list-style-type: none"> <li>establish internal controls for monitoring adherence to established policies and procedures</li> </ul>   | <ul style="list-style-type: none"> <li>same</li> </ul>   |
| <ul style="list-style-type: none"> <li>submit annual compliance reports to the SEC</li> </ul>   | <ul style="list-style-type: none"> <li>same</li> </ul>   |
| <ul style="list-style-type: none"> <li>take actions to prevent sales and marketing considerations from affecting ratings</li> </ul>   | <ul style="list-style-type: none"> <li>take actions to prevent sales and marketing considerations from affecting voting recommendations</li> </ul>                             |
| <ul style="list-style-type: none"> <li>set qualifications standards for credit analysts</li> </ul>  | <ul style="list-style-type: none"> <li>set qualification standards for proxy analysts</li> </ul>   |
| <ul style="list-style-type: none"> <li>establish procedures for assessing possible conflicts of interest with former employees</li> </ul>   | <ul style="list-style-type: none"> <li>same</li> </ul>   |
| <ul style="list-style-type: none"> <li>maintain an independent board or board committee tasked with certain responsibilities related to the credit ratings agency business</li> </ul> | <ul style="list-style-type: none"> <li>maintain an independent board or board committee tasked with certain responsibilities related to the proxy advisory business</li> </ul> |
| <ul style="list-style-type: none"> <li>publicly disclose ratings methodologies and a description of the underlying data used in the ratings process</li> </ul>                        | <ul style="list-style-type: none"> <li>publicly disclose vote methodologies and description of underlying data used in deriving vote recommendations</li> </ul>                |
| <ul style="list-style-type: none"> <li>periodically disclose information on the historical accuracy of credit ratings</li> </ul>  | <ul style="list-style-type: none"> <li>periodically disclose information on the accuracy of vote recommendations</li> </ul>  |

**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.<sup>188</sup> 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.”<sup>189</sup> 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.”<sup>190</sup> 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.<sup>191</sup> “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.”<sup>192</sup>

**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.<sup>193</sup> “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.”<sup>194</sup>

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.<sup>195</sup>

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 significant 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.”<sup>196</sup>

## **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.<sup>197</sup> 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.<sup>198</sup>

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."<sup>199</sup> 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.<sup>200</sup> 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.”<sup>201</sup> 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.”<sup>202</sup>

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.<sup>203</sup> 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.”<sup>204</sup> 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.”<sup>205</sup> 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.<sup>206</sup> Proxy Governance entered into an agreement with ISS’ competitor, Glass Lewis, to assume all of their customer contracts.<sup>207</sup>

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.”<sup>208</sup>

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.”<sup>209</sup> 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 be affecting the quality of voting recommendations from ISS and other proxy advisors.<sup>210</sup>

## **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 better 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 been made that the interests of investors, issuers and the public would be 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.”<sup>211</sup> 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.”<sup>212</sup> 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.<sup>213</sup>

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.<sup>214</sup>

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.)<sup>215</sup> 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.<sup>216</sup>

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.<sup>217</sup>

More recent 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.<sup>218</sup> 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.<sup>219</sup> 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.<sup>220</sup>

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.”<sup>221</sup>

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.<sup>222</sup> 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.”<sup>223</sup>

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.<sup>224</sup> 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.”<sup>225</sup> 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.<sup>226</sup> 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.<sup>227</sup>

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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- <sup>13</sup> HR Policy Ass'n, 2010 Summer Chief Human Resource Officer Survey, Sept. 1, 2010.
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- <sup>15</sup> Press Release, Yale Univ. Office of Pub. Affairs, SOM Event Explores the Origins of Shareholder Activism Around the World (Oct. 30, 2009).
- <sup>16</sup> Stuart L. Gillan & Laura T. Starks, *The Evolution of Shareholder Activism in the United States*, 19 JOURNAL OF APPLIED CORPORATE FINANCE 55 (Winter 2007).
- <sup>17</sup> The rule was first designated Rule X-14 A7. See Sec. Exch. Act Rel. No. 3347 (Dec. 18, 1942). This rule is a predecessor to current SEC Rule 14a-8, 17 C.F.R. § 240.
- <sup>18</sup> Gillan, *supra* note 16.
- <sup>19</sup> THE CONFERENCE BOARD, 2008 INSTITUTIONAL INVESTMENT REPORT: TRENDS IN INSTITUTIONAL INVESTOR ASSETS AND EQUITY OWNERSHIP OF U.S. CORPORATIONS (Sept. 2008).
- <sup>20</sup> NACD Directorship, *Institutional Ownership Multiplies*, Sept. 2, 2008, <http://www.directorship.com>.
- <sup>21</sup> THE CONFERENCE BOARD, *supra* note 19.
- <sup>22</sup> While the S&P 500 Index dates back to 1957, index investing was not readily available until the early 1970s, when several investment managers – including John McQuown and David Booth at Wells Fargo, Rex Sinquefeld at American National Bank, and John Bogle, the founder of Vanguard Group -- recognized that most mutual fund managers were not outperforming broad market indices and launched index funds. The concept met with skepticism at first, but became increasingly popular as growing numbers of investors accepted an economic theory known as the efficient-market hypothesis, which held that all relevant new information about a company's prospects was rapidly incorporated into stock prices. By the early 1980s, major indexing firms, such as Dimensional Fund Advisors, Batterymarch and the Russell Investments, were launching equity indices or funds aimed at large institutional investors.
- <sup>23</sup> BROADRIDGE INVESTOR COMMUNICATION SOLUTIONS, *supra* note 14.

<sup>24</sup> 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).

<sup>25</sup> *Id.*; See also Dep’t of Labor Interpretive Bulletin 94-2 (July 29, 1994) (In this subsequent interpretive bulletin, the Department of Labor reiterated and augmented the Avon Letter extending the fiduciary principles regarding proxy voting to the shares of foreign corporations).

<sup>26</sup> 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).

<sup>27</sup> *Id.*

<sup>28</sup> *Id.*

<sup>29</sup> 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).

<sup>30</sup> Charles M. Nathan, *The Parallel Universes of Institutional Investing and Institutional Voting*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, April 6, 2010,

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<sup>31</sup> Charles M. Nathan, *The Future of Institutional Share Voting: Three Paradigms*, HARVARD LAW SCHOOL FORUM ON CORPORATE GOVERNANCE AND FINANCIAL REGULATION, July 23, 2010,

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<sup>32</sup> Sec. Exch. Comm’n, Compliance Alert, July 2008, <http://www.sec.gov/about/offices/ocie/complialert0708.htm>.

<sup>33</sup> Gibson, Dunn & Crutcher, LLP, *SEC Enforcement Action Focuses on Investment Adviser’s Proxy Voting Policies and Procedures* (May 21, 2009).

<sup>34</sup> Press Release, Sec. Exch. Comm’n, SEC Votes to Seek Public Comment on U.S. Proxy System (July 14, 2010).

<sup>35</sup> New York Stock Exchange Comm’n on Corp. Governance, *Report of the New York Stock Exchange Commission on Corporate Governance*, Sept. 23, 2010, at 15 <http://www.nyse.com/pdfs/CCGReport.pdf>.

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<sup>37</sup> Leo E. Strine Jr., *The Delaware Way: How We Do Corporate Law and Some of the New Challenges We (And Europe) Face*, 30 Del. J. Corp. L. 673, 688 (2005).

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<sup>39</sup> Dean Starkman, *A Proxy Adviser’s Two Sides: Some Question Work of ISS for Companies it Scrutinizes*, WASH. POST, Jan. 23, 2006, at D1.

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<sup>41</sup> Bethel, *supra* note 3, at 30.

<sup>42</sup> Ernst G. Maug & Kristian Rydqvist, *Do Shareholders Vote Strategically? Voting Behavior, Proposal Screening, and Majority Rules* (European Corp. Governance Inst., Working Paper No. 31, 2006).

<sup>43</sup> Alexander, *supra* note 3.

<sup>44</sup> *Id.* at 26-27.

<sup>45</sup> *Id.* at 32.

<sup>46</sup> Stephen Choi, Jill Fisch & Marcel Kahan, *Director Elections and the Influence of Proxy Advisors* 51 (N.Y.U. School of Law, Law & Econ. Research Paper Series, Working Paper No. 08-22, 2008).

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<sup>49</sup> Elizabeth Amon, *Will Majority Voting Prevail in Corporate Elections*, CORPORATE COUNSEL, July 21, 2006, available at <http://www.law.com/jsp/cc/PubArticleCC.jsp?id=900005458428>.

<sup>50</sup> Council of Institutional Investors, *Majority Voting for Directors*, <http://www.cii.org/resourcesKeyGovernanceIssuesMajorityVotingForDirectors>.

<sup>51</sup> RiskMetrics Group, *2010 Postseason Report*, at 44.

<sup>52</sup> The percentage of smaller companies who have adopted majority voting is much lower – approximately 25 percent according to a 2008 study. See Annalisa Barrett & Beth Young, *Majority Voting in Director Elections – It is Not Yet Standard Practice*, THE CORPORATE LIBRARY (Dec. 2008).

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<sup>54</sup> Troubled Assets Relief Program, Pub. L. No. 110-343, 122 Stat. 3765 (2008).

<sup>55</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

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<sup>57</sup> Press Release, Towers Watson, *Few U.S. Companies Well Prepared for Executive Say on Pay Legislation*, Towers Watson Survey Finds (June 29, 2010), <http://www.towerswatson.com/united-states/press/2373>.

<sup>58</sup> Gribben, *supra* note 6.

<sup>59</sup> Mary Hughes, *Heightened SEC Expectations for Disclosure May Require Amended Filings*, *Official Says*, DAILY REPORT FOR EXECUTIVES, June 3, 2010.

<sup>60</sup> Peter C. Clapman, *Next Steps? Be Careful What You Wish For*, DIRECTORS & BOARDS, Summer 2008, <http://www.entrepreneur.com/tradejournals/article/181776560.html>.

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<sup>63</sup> Skadden, Arps, Slate, Meagher & Flom, LLP & Affiliates, *The Dodd-Frank Act: Commentary and Insights* 93 (July 12, 2010).

<sup>64</sup> Press Release, Sec. Exch. Comm’n, *SEC Adopts New Measures to Facilitate Director Nominations by Shareholders* (Aug. 25, 2010).

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<sup>66</sup> Sec. Exch. Comm’n, *Final Rule: Shareholder Proposals Relating to the Election of Directors*, Release No.34-56914; File No. S7-17-07, 17C.F.R § 240 (Jan. 10, 2008).

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<sup>71</sup> Institutional Shareholder Services, Inc., Uniform Application (Form ADV) (Mar. 31, 2010). Form ADV is an annual SEC filing made by registered investment advisers.

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<sup>73</sup> Aaron Lucchetti, *MSCI Seizes RiskMetrics in Union of Niche Firms*, WALL ST. J., March 2, 2010.

<sup>74</sup> John Greenwald, *What's Next for Caesar's Wife?*, CORPORATE BOARD MEMBER, 2<sup>nd</sup> Quarter 2010.

<sup>75</sup> RiskMetrics Group, Annual Report (Form 10-K) (Feb. 24, 2010).

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<sup>77</sup> *Id.*

<sup>78</sup> *Id.*

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<sup>80</sup> RiskMetrics Group, *supra* note 75, at 17.

<sup>81</sup> See, e.g., Robert Daines, Ian Gow & David Larcker, *Rating the Ratings: How Good are Commercial Corporate Governance Ratings?* (Stanford Univ. Sch. of Law, Law & Econ. Research Paper Series, Paper No. 360, Sept. 4, 2009).

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<sup>83</sup> Gretchen Morgenson, *How to Succeed on Wall Street, Conflict-Free*, N.Y. TIMES, Dec. 19, 2004.

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<sup>101</sup> Proxy Governance, Inc., *supra* note 100, at 1.

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- <sup>115</sup> Leslie Wayne, *Have Shareholder Activists Lost Their Edge?*, N.Y. TIMES, Jan. 30, 1994, at C7.
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- <sup>121</sup> *Id.*; Edward F. Smith, NACD Directorship, *White Knight Swoops in for Glass Lewis*, Dec. 1, 2007, <http://www.directorship.com/white-knight-swoops-in-for-glass-lewis/>.
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- <sup>123</sup> *Id.* at 5.
- <sup>124</sup> *Id.*
- <sup>125</sup> *Id.* (containing both documents).
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- My company has purchased services from ISS Corporate Services ("ICS"). May I note that fact during our engagement with the ISS research analysts?
- 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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- <sup>142</sup> See, e.g., Tom Brown, *Egan-Jones is Conflict-Free? Not a Chance*, SEEKING ALPHA, Feb. 12, 2008.
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- <sup>160</sup> Target Corp., *White Paper on the RiskMetrics Report on Target Corporation*, Proxy Statement (Schedule 14A) (May 21, 2009).
- <sup>161</sup> Investment Advisers Act of 1940, § 202(a)(11), 15 U.S.C. § 80b-2(a)(11).
- <sup>162</sup> Sec. Exch. Comm'n, *supra* note 116, at 110.
- <sup>163</sup> *Id.*
- <sup>164</sup> See Sec. Exch. Comm'n vs. Capital Gains Research Bureau Inc., 375 U.S. 180 (1963).
- <sup>165</sup> Sec. Exch. Comm'n, *supra* note 116, at 119.
- <sup>166</sup> National Securities Markets Improvements Act of 1996, Pub. L. 104-290, 110 Stat. 3416 (1996).
- <sup>167</sup> Investment Advisers Act of 1940 § 203A-2, 15 U.S.C. § 80b-3a(a).
- <sup>168</sup> 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, *supra* note 92.
- <sup>169</sup> Investment Advisers Act of 1940 § 206-2, 15 U.S.C. § 80b-6(2).
- <sup>170</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 12.
- <sup>171</sup> *Id.*
- <sup>172</sup> *Id.*
- <sup>173</sup> Gibson, Dunn & Crutcher, LLP, *supra* note 33.
- <sup>174</sup> *Id.*
- <sup>175</sup> Sec. Exch. Comm'n, *supra* note 116, at 108-09.
- <sup>176</sup> *Id.* at 110.

- <sup>177</sup> Strine, Jr., *supra* note 38, at 11.
- <sup>178</sup> Belinfanti, *supra* note 1, at 40.
- <sup>179</sup> 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).
- <sup>180</sup> Proposed 29 C.F.R. § 2510.3-21(c)(1)(ii)(C).
- <sup>181</sup> Dep't of Labor, *supra* note 179, at 65,266.
- <sup>182</sup> 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.
- <sup>183</sup> 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).
- <sup>184</sup> Press Release, *supra* note 34.
- <sup>185</sup> *Id.*
- <sup>186</sup> Belinfanti, *supra* note 1, at 54.
- <sup>187</sup> *Id.* at 53-54.
- <sup>188</sup> 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).
- <sup>189</sup> 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).
- <sup>190</sup> *Id.* at 4.
- <sup>191</sup> *Id.*
- <sup>192</sup> *Id.*
- <sup>193</sup> Thompson-Mann, *supra* note 10, at 18.
- <sup>194</sup> *Id.*
- <sup>195</sup> Paul Rose, *The Corporate Governance Industry*, J. CORP. L. 138 (Summer 2007) (citation omitted).
- <sup>196</sup> Center On Executive Compensation, *supra* note 159, at 4.
- <sup>197</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 12.
- <sup>198</sup> See Gibson, Dunn & Crutcher, LLP, *supra* note 33.
- <sup>199</sup> Rose, *supra* note 195, at 13.
- <sup>200</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 13.
- <sup>201</sup> *Id.* at 15.
- <sup>202</sup> *Id.* at 13.
- <sup>203</sup> Belinfanti, *supra* note 1, at 28.
- <sup>204</sup> *Id.* at 30.
- <sup>205</sup> 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>.
- <sup>206</sup> Press Release, *supra* note 92.
- <sup>207</sup> *Id.*
- <sup>208</sup> U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 9, at 14-15.
- <sup>209</sup> Comment letter from Troutman Sanders, LLP, to Jonathan G. Katz, Sec'y, Sec. Exch. Comm'n (Nov. 22, 2002).
- <sup>210</sup> Sec. Exch. Comm'n, *supra* note 116, at 124.
- <sup>211</sup> 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).
- <sup>212</sup> *Id.*
- <sup>213</sup> Press Release, *supra* note 92.
- <sup>214</sup> 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).
- <sup>215</sup> 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).

<sup>216</sup> BROADRIDGE INVESTOR COMMUNICATION SOLUTIONS, *supra* note 14.

<sup>217</sup> 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).

<sup>218</sup> Sec. Exch. Comm'n, Amendments to Rules Requiring Internet Availability of Proxy Materials, Release Nos. 33-9073; 34-60825, at 7 (Oct. 14, 2009).

<sup>219</sup> 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).

<sup>220</sup> NYSE Proxy Working Group, *August 27, 2007 Addendum to Report and Recommendation of the Proxy Working Group to the New York Stock Exchange Dated June 5, 2006* 5 (Aug. 27, 2007).

<sup>221</sup> 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).

<sup>222</sup> 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/>.

<sup>223</sup> *Id.*

<sup>224</sup> 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).

<sup>225</sup> Comment letter from James McRitchie, Publisher, Corporate Governance Int'l, to Elisabeth M. Murphy, Sec'y, Sec. Exch. Comm'n (July 16, 2010).

<sup>226</sup> See Moxy Vote, <http://www.moxyvote.com>.

<sup>227</sup> See Proxy Democracy, <http://www.proxydemocracy.org>.