



## THE CONFERENCE BOARD

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845 Third Avenue, New York, NY 10022-6600

December 30, 2013

Ms. Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549-1090

### **Re: Proxy Advisory Firm Roundtable (File Number 4-670)**

Dear Ms. Murphy:

The Conference Board Governance Center is a non-profit, non-advocacy research group that convenes companies and their investors to work together on issues of concern in corporate governance. During 2013, we convened a Task Force on Corporate/Investor Engagement comprised of directors of public companies and institutional investors. In order to complete its mission, the Task Force convened a series of public forums, received reports from an advisory board of governance experts and commissioned research, with a goal of identifying how public companies and their investors should engage with each other in a way that sustains the public corporation as an engine of growth and economic prosperity for Americans. Some of the research generated in this effort addresses the role of proxy advisors in corporate governance. We hope that sharing this research with the Commission, which is summarized below, will help in resolving the issues raised at the Roundtable.

### **The Growth in Importance of Proxy Advisory Firms in the Shareholder Voting Process.**

Proxy advisory firms began offering services to help investors analyze and vote company proxies beginning in 1972, with the founding of the not-for-profit Investor Responsibility Research Center. Today, two proxy advisory firms – Institutional Shareholder Services Inc. (“ISS”) and Glass Lewis & Co., LLC (“Glass Lewis”) – represent roughly 97% of the U.S. proxy advisory market.<sup>1</sup> In addition to company-specific reports and voting recommendations, both ISS and Glass Lewis release extensive annual voting policies that reflect the firms’ determinations of “best practices” for all companies. These annual voting policies provide voting guidelines on a wide range of potential topics – from recapitalization plans to

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<sup>1</sup> James K. Glassman and J.W. Verret, “How to Fix our Broken Proxy Advisory System,” *Mercatus Research*, April 16, 2013, p. 8, FN12 ([http://mercatus.org/sites/default/files/Glassman\\_ProxyAdvisorySystem\\_04152013.pdf](http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf)).

proposals requiring disclosure regarding animal welfare standards to the company policies that the proxy advisory firms believe merit automatic votes against nominated directors.

With the increase in the size of institutional investors' portfolios, the complexity of proxy statements, and regulatory and market pressures on institutional investors to responsibly exercise their votes, the use of proxy advisory services and the consequent influence of proxy recommendations have also grown. According to the Mercatus Center, U.S. issuers pose more than 250,000 proxy questions each year, and it is not unusual for large mutual funds and their advisers to be required to cast votes on more than 100,000 of them.<sup>2</sup> At the same time, the issues required to be included in company proxies, including, notably, Say on Pay, have grown more complicated, and can require substantial company-specific analysis. As described by TIAA-CREF in 2010, "[t]hough we dedicate a significant amount of resources to corporate governance research and the voting of proxies, we still would have difficulty processing the 80,000 plus unique agenda items voted by our staff annually without utilizing [proxy advisory firm] research."<sup>3</sup> A survey of institutional investors suggests that there is considerable variation in the manner in which proxy advisory services are used, and that the degree of reliance on the services may depend more on firm-specific factors, like resource constraints and perceptions regarding the value of voting, than on sector-specific characteristics like investment strategy (e.g., "passive" or "active" funds).<sup>4</sup>

There are three main channels through which proxy advisory firms influence corporate governance. The most direct is through company-specific voting recommendations that sway voting outcomes. While most observers acknowledge proxy advisory firms' influence on voting results, the actual percentage of votes that are decided based on the recommendations is disputed. A 2010 study of director elections estimated that 6 to 10% of votes were shifted as a result of an ISS recommendation;<sup>5</sup> other studies have suggested figures greater than 25%.<sup>6</sup> In comment letters to the Securities and Exchange Commission ("SEC"), companies have cited evidence from interim vote reports that a significant number of investors vote "lock-step" with

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<sup>2</sup> *Id.*

<sup>3</sup> Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Jonathan Feigelson, Senior VP, General Counsel, and Head of Corporate Governance, TIAA-CREF, re: Concept Release on the U.S. Proxy System, File No. S7-14-10, November 8, 2010, p. 5 (<http://www.sec.gov/comments/s7-14-10/s71410-263.pdf>).

<sup>4</sup> Robyn Bew and Richard Fields, "Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers," *IRRC Institute / Tapestry Networks*, June 2012 ([http://www.irrcinstitute.org/pdf/Voting\\_Decisions\\_at%20US\\_Mutual\\_Funds.pdf](http://www.irrcinstitute.org/pdf/Voting_Decisions_at%20US_Mutual_Funds.pdf)).

<sup>5</sup> Stephen Choi, Jill Fisch, and Marcel Kahan, "The Power of Proxy Advisors: Myth or Reality?," *Emory Law Journal* 59, 2010, p. 869.

<sup>6</sup> See Yonca Ertimur, Fabrizio Ferri, and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," *Journal of Accounting Research (Forthcoming)*, 2013, p. 3 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2019239](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2019239)); "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight," *Center on Executive Compensation*, January 2011, p. 11 (<http://www.excecomp.org/docs/>). The different measurements may reflect the fact that different studies focus on different types of votes (e.g., director elections versus compensation) and make different types of distinctions (e.g., a Glass-Lewis versus an ISS recommendation, or both). In comparison to Choi's work, for example, a study of management-sponsored proposals pertaining to compensation programs found that opposition by a proxy advisor resulted in a "20% increase in negative votes cast." David F. Larcker, Allan L. McCall, and Gaizka Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms," *Rock Center for Corporate Governance at Stanford University Working Paper No. 119*, May 10, 2013, p. 12 ([http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2101453](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2101453)).

proxy advisory recommendations.<sup>7</sup> IBM, for example, reported that the votes cast that exactly mirrored ISS recommendations during the business day immediately following release of the ISS recommendations ultimately amounted to approximately 11.9% of total votes cast, whereas no more than 0.27% of total IBM votes were cast in any of the five immediately preceding business days.<sup>8</sup>

A second, related channel of influence is with respect to the development of in-house voting policies, the development and disclosure of which became mandatory for registered investment advisers when the SEC adopted Rule 206(4)-6 in 2003. One reason for the rule-making was an effort by the SEC to address investment advisers' own potential conflicts of interest when voting clients' proxies. In the adopting release, the SEC noted 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>9</sup> One year later, in response to requests for clarity about the new rules, the SEC staff issued two no-action letters containing guidance that was viewed by many as establishing a "safe harbor" against charges of conflict of interest if a registered adviser relied on an independent proxy advisory firm's voting recommendations, as long as the investor had appropriate written policies and procedures in place to mandate such reliance, and made appropriate disclosures to its clients.<sup>10</sup> Such an interpretation provided incentive for registered investment advisers to look to proxy advisory guidelines and other input to establish their own internal voting policies, with the consequence of generating voting outcomes that reflect the ultimate recommendations of proxy advisory firms even when the advisers are not seeking or intentionally following recommendations in a particular year.<sup>11</sup>

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<sup>7</sup> Kenneth L. Altman and James F. Burke, "Proxy Advisory Firms: The Debate Over Changing the Regulatory Framework: An Analysis of Comments Submitted to the SEC in Response to the Concept Release on the U.S. Proxy System," *The Altman Group*, March 1, 2011, pp. 11-13. (<http://www.altmangroup.com/pdf/TAGSpecRptProxyAdv.pdf>).

<sup>8</sup> Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Andrew Bonzani, Vice President, Assistant General Counsel and Secretary, IBM, Armonk, New York, October 15, 2010 (<http://www.sec.gov/comments/s7-14-10/s71410-84.pdf>).

<sup>9</sup> Proxy Voting by Investment Advisers, Release No. IA-2106, SEC (<http://www.sec.gov/rules/final/ia-2106.htm>).

<sup>10</sup> See SEC Commissioner Daniel M. Gallagher, Remarks at Society of Corporate Secretaries & Governance Professionals' 67th National Conference, Seattle, WA, July 11, 2013 (<http://www.sec.gov/News/Speech/Detail/Speech/1370539700301#.Um1gzKuUpyw>) ("Commissioner Gallagher Speech"). The requests for guidance were submitted by ISS and Egan-Jones Proxy Services. In its response to Egan-Jones, the SEC advised that "[a]n investment adviser that votes client proxies in accordance with a pre-determined policy based on the recommendations of an independent third party will not necessarily breach its fiduciary duty of loyalty to its clients even though the recommendations may be consistent with the adviser's own interests. In essence, the recommendations of a third party that are in fact independent of an investment adviser may cleanse the vote of the adviser's conflict." *Egan-Jones Proxy Services*, SEC No-Action Letter, May 27, 2004 (<http://www.sec.gov/divisions/investment/noaction/egan052704.htm>); See also *Institutional Shareholder Services, Inc.*, SEC No-Action Letter, September 15, 2004 (<http://www.sec.gov/divisions/investment/noaction/iss091504.htm>).

<sup>11</sup> See e.g., Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Karrie McMillan, General Counsel, Investment Company Institute, Washington, DC, October 20, 2010 (<http://www.sec.gov/comments/s7-14-10/s71410-167.pdf>), which describes a 2008 study by the Investment Company Institute of 3.5 million proxy votes cast in 2007 by 160 of the largest fund families. The study found that fund voting patterns were broadly consistent with vote recommendations of proxy advisory firms, but that the funds did not reflexively adopt the recommendations of proxy advisors.

The third channel through which proxy advisory firms influence corporate governance is by impacting the governance decisions made by boards and management, who, cognizant of the potential influence of proxy advisory firm recommendations on shareholder votes, incorporate anticipated proxy advisory firm reactions into their decision-making when determining what their corporate policies should be.<sup>12</sup> For example, in a 2011 study by the Conference Board, Nasdaq and the Rock Center for Corporate Governance at Stanford University, 70.4% of companies reported that direct or indirect guidance by proxy advisory firms influenced the features of their compensation programs.<sup>13</sup>

The influence of proxy advisory firms (and company concerns regarding it) has come to the attention of regulatory agencies, both in the United States and abroad. In addition to the July 2010, concept release on the U.S. proxy system issued by the SEC, in June 2013, a subcommittee of the Financial Services Committee of the U.S. House of Representatives held a hearing entitled “Examining the Market Power and Impact of Proxy Advisory Firms.” Both of these actions spurred significant input from companies, institutional investors, academics and other analysts. In February 2013, the European Securities and Markets Authority (“ESMA”) released a final report that concluded the evidence collected did not yet support binding measures for the proxy advisory industry. ESMA recommended a proxy advisory industry “code of conduct” to address, in particular, improving transparency and disclosure, and a review of whether regulatory action was needed after a period of operating under the code of conduct.<sup>14</sup> Canadian regulators found evidence to support regulatory action and, in September 2013, announced that they expect to propose a regulatory approach to proxy advisory firms based on recommended practices and disclosure.<sup>15</sup>

### **Do Proxy Advisory Firms Replace, Rather than Augment, the Shareholder Voice, and Should the Proxy Advisory Industry Be Subject to Greater Regulation and Oversight?**

Modern shareholders, and institutional shareholders in particular, face a substantial task in exercising their proxy votes. Given the large number of voting opportunities for many institutional investors, the complexity of many of the issues on which votes are taken, and the relatively small financial interest of most institutional investors in any particular matter put to a vote, it is rational for institutional investors to seek outside support. And, just as companies are entitled to seek counsel for complex tasks, an institutional investor’s decision to secure the support of proxy advisory firms is a legitimate exercise of managerial discretion.

A number of commentators have, however, expressed significant concerns about the role of the dominant proxy advisory firms – ISS and Glass Lewis – in the shareholder voting

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<sup>12</sup> Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Tina Davis, Senior Vice President, tw telecom inc. Littleton, CO, October 20, 2010 (<http://www.sec.gov/comments/s7-14-10/s71410-162.pdf>).

<sup>13</sup> David F. Larcker, Allan L. McCall, and Brian Tayan, “The Influence of Proxy Advisory Firm Voting Recommendations on Say-on-Pay Votes and Executive Compensation Decisions,” *The Conference Board: Director Notes*, March 2012, p. 4.

<sup>14</sup> “Final Report: Feedback statement on the consultation regarding the role of the proxy advisory industry,” 2013/84, ESMA (<http://www.esma.europa.eu/system/files/2013-84.pdf>)

<sup>15</sup> “Update on CSA Consultation Paper 25-401 Potential Regulation of Proxy Advisory Firms,” CSA Notice 25-301 ([www.osc.gov.on.ca/en/SecuritiesLaw\\_csa\\_20130919\\_25-301\\_update-25-401.htm](http://www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130919_25-301_update-25-401.htm)), which says the Canadian Securities Administrators (“CSA”) intends to publish for comment a proposal that would promote transparency and understanding in the services provided by proxy advisory services by the first quarter of 2014.

process, and as a result, the industry has come under increasing scrutiny by regulators. The scrutiny of proxy advisory firms is three-fold:

- charges regarding transparency and potential conflicts of interest at the firms drive concerns about the legitimacy of their voting recommendations;
- charges about the reliance of institutional investors on proxy advisor recommendations drive concerns that the recommendations displace meaningful institutional investor input in the voting process; and
- charges about companies conforming to the “best practice” models of the firms drive concerns about the governance repercussions of forcing a diverse field of corporations into a “one-size-fits-all” box that may not enhance shareholder value.

With respect to operations and internal processes, companies and other commentators contend that there is little visibility into the analytical process that guides proxy advisory firms’ recommendations, particularly for issues the firms indicate they will assess on a “case-by-case” basis. ISS provides limited opportunity for American companies to fact check company reports prior to publication. Advanced review is only offered to companies in the S&P 500 and then only with respect to non-controversial issues, and, according to companies, pursuant to a short turnaround time and no real opportunity to review the rationale for recommendations or how various factors are weighed in arriving at those decisions.<sup>16</sup> Glass Lewis does not permit review of its company reports prior to their release.

ISS defends its limited interaction with evaluated companies regarding its specific recommendations as intended to ensure the independence of its process and recommendations.<sup>17</sup> The firm also points to its engagement with companies, institutional investors and industry constituents through roundtables, surveys and an open-comment period as it develops its annual policy guidelines, which themselves are publicly available and inform ultimate ISS recommendations.<sup>18</sup> Still, critics charge that this engagement too has its problems, including with respect to how the feedback is incorporated into the policy guidelines and how the feedback informs application of the policy guidelines to actual voting recommendations. For example, in 2013, ISS reported that it would consider a new policy recommending that investors vote against directors of a company if the directors fail to act on a shareholder proposal receiving majority support of votes cast during the previous year. Various companies, including Pfizer, Eli Lilly, FedEx and Honeywell, protested that this policy directive could run counter to a board’s fiduciary duties to act in a manner that it believes to be in the best interests of the company and all of its shareholders.<sup>19</sup> In its 2013-2014 policy survey, ISS reported that 40% of institutional

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<sup>16</sup> “Frequently Asked Questions on US Policy Interpretation and Research,” ISS, August 28, 2012 (<http://www.issgovernance.com/policy/USResearchFAQ>). ISS does not allow companies to fact-check those issues that ISS has, in its sole discretion, determined are controversial.

<sup>17</sup> “Engaging with ISS: Process for Engagement on Proxy Voting Matters,” ISS, July 2012 (<http://www.issgovernance.com/policy/EngagingWithISS>).

<sup>18</sup> “ISS Comments on Principles Regarding the Proxy Advisory Industry Derived from ESMA’s Analysis,” ISS, March 18, 2013 (<http://www.issgovernance.com/press/esmaprinciples>).

<sup>19</sup> David F. Larker, Allan L. McCall, and Brian Tayan, “And Then A Miracle Happens!: How Do Proxy Advisory Firms Develop Their Voting Recommendations?” Stanford Closer Look Series, February 25, 2013, p. 3 ([http://www.gsb.stanford.edu/sites/default/files/31\\_MiracleHappens.pdf](http://www.gsb.stanford.edu/sites/default/files/31_MiracleHappens.pdf)).



investors indicated that a board should be free to exercise its discretion to respond to a majority-shareholder proposal in a manner it believes is in the best interests of the company, 92% of issuer respondents indicated the same, and only 36% of institutional investors indicated that the board should implement a specific action to address a proposal with majority shareholder support.<sup>20</sup> Yet, ISS nonetheless implemented a policy for 2014 elections to recommend a vote against individual directors, committee members, or the entire board of directors, as appropriate, if the board failed to act on a shareholder proposal that received the support of a majority of the shares cast in the previous year.<sup>21</sup> Although ISS states that it will make recommendations to vote against the re-election of directors after considering company specific issues, this assurance does not satisfy concerns about the conflict between directors' fiduciary duties to consider the best interests of the company and all of its investors and the policy which requires directors to take action approved by some investors, but not necessarily a majority of the total shares outstanding. There are at least two dozen of the largest 1000 companies that have had investor proposals approved by a majority of votes cast in the 2013 annual meeting, but not by a majority of the outstanding shares.<sup>22</sup>

Conflict of interest charges regarding the proxy advisory firms focus on the ownership of Glass Lewis and the services provided by ISS. As a subsidiary of Ontario Teachers' Pension Plan Board and Alberta Investment Management, Glass Lewis has been described as having a "built-in" conflict of interest, as its owners – as active investors with a particular set of constituents – have their own economic and other interests in the proxy outcomes of various companies that Glass Lewis reviews.<sup>23</sup> Potential ISS conflicts of interest stem from its advisory services to both institutional investor and company clients. Specifically, ISS provides governance ratings of companies and voting advice to institutional investor clients at the same time as it provides structural governance advice to company clients about how to improve the policies, structures and proposals they may be evaluating. Critics charge that this provides opportunities for companies to "game" the system, and can create pressure on companies to purchase governance advice from ISS to improve their ISS ratings.<sup>24</sup> In addition, both Glass Lewis and ISS issue recommendations with respect to proposals submitted by shareholder clients.

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<sup>20</sup> ISS reported that 128 institutional investors responded to the survey, approximately 46% of which had the U.S. as their market of focus, and 350 corporate issuers responded to the survey, 80% of which had the U.S. as their market of focus. "2013 - 2014 Policy Survey Summary of Results," ISS, October 2013

(<http://www.issgovernance.com/files/ISS2013-2014PolicySurveyResultsReport.pdf>).

<sup>21</sup> U.S. Corporate Governance Policy, 2014 Updates, November 21, 2013

(<http://www.issgovernance.com/files/2014USPolicyUpdates.pdf>)

<sup>22</sup> Liz Hoffman, "Little-Known ISS Change Shakes up Boards" Wall Street Journal, December 27, 2013

([http://online.wsj.com/news/article\\_email/SB10001424052702304244904579276871340085280-1MyQjAxMTAzMDIwNzEyNDcyWj](http://online.wsj.com/news/article_email/SB10001424052702304244904579276871340085280-1MyQjAxMTAzMDIwNzEyNDcyWj))

<sup>23</sup> See Letter to Elizabeth Murphy, Secretary, SEC, from Edward S. Knight, Executive VP, General Counsel and Chief Regulatory Officer, NASDAQ OMX, re: Petition Related to Proxy Advisory Firms, File No. 4-666

(<http://www.sec.gov/rules/petitions/2013/petn4-666.pdf>) at p. 8

<sup>24</sup> Scott Fenn, "A Call for Change in the Proxy Advisory Industry Status Quo: The Case for Greater Accountability and Oversight," *Center on Executive Compensation*, January 2011, pp. 7-8

(<http://online.wsj.com/public/resources/documents/ProxyAdvisoryWhitePaper02072011.pdf>); *Journal of Corporate Law*, 120-121; "Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting," *U.S. Government Accountability Office*, Rep. No. GAO-07-765, June 2007, pp. 7-8 (<http://www.gao.gov/new.items/d07765.pdf>).

Both companies have policies they believe respond to these charges. Glass Lewis has committed to indicating whether the Ontario Teachers' Pension Plan Board or Alberta Investment Management Corp. has a substantial interest in a particular company in the research report of that company.<sup>25</sup> ISS has conflict management policies and procedures that create physical, electronic and ethical (via annual certification to the company's code of ethics) separations between its company advisory and institutional investor advisory services,<sup>26</sup> and will provide institutional investor clients with a list of its company clients upon request.<sup>27</sup>

Still, transparency and conflict of interest concerns remain strong. In an October 2013 letter, Nasdaq cited the concerns in a petition asking the SEC to modify its 2004 guidance permitting certain registered investment advisers to rely on proxy advisory firm recommendations.<sup>28</sup> Specifically, Nasdaq asked that the SEC condition institutional investor reliance on a proxy advisory firm's disclosure of (i) the models, formulas and methodologies pursuant to which it develops its voting recommendations, and (ii) all relationships that might give rise to conflicts of interest. In the letter, Nasdaq charged: "as they operate today [proxy advisory firms'] services cannot be evaluated in a meaningful manner . . . Unless we enable companies and all market participants to have full information about [their] practices and activities . . . [they] will continue to exert outsized influence from the shadows in which they operate and profit."<sup>29</sup>

The second major concern about proxy advisory firms is the extent of influence of the firms' recommendations on proxy voting outcomes. Based on their tabulated voting results and their knowledge about the voting policies of some of their institutional investors, many companies have concluded that a sizable portion of their investors rely heavily on – and in some cases, "blindly follow" – the advice of proxy advisory firms. In comment letters to the SEC, General Mills and ExxonMobil estimated that 20 and 25-30%, respectively, of their company shares are voted by shareholders who look to ISS for guidance. In addition to IBM (as described above), UnitedHealth Group and Johnson & Johnson are among those companies that noted a substantial increase in the number of votes that mirrored proxy advisory recommendations in the days immediately following the issuance of the recommendations. A 2008 study by the Investment Company Institute ("ICI") of 3.5 million proxy votes cast in 2007 by 160 of the largest fund families found that voting patterns among the funds were broadly consistent with voting recommendations of proxy advisory firms even though, the study found, funds did not reflexively adopt the recommendations of proxy advisors.<sup>30</sup> This has led some to conclude that many institutional investors have established internal voting policies based on proxy advisory firm guidelines and related advice.

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<sup>25</sup> "Conflict of Interest Statement," *Glass Lewis* (<http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/>).

<sup>26</sup> "ISS Comments on Principles Regarding the Proxy Advisory Industry Derived from ESMA's Analysis," ISS, March 18, 2013 (<http://www.issgovernance.com/press/esmaprinciples>).

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

<sup>28</sup> NASDAQ OMX, re: Petition Related to Proxy Advisory Firms, *supra*, note 24, p. 1

<sup>29</sup> *Id.* p. 2

<sup>30</sup> Letter to Elizabeth Murphy, Secretary, Div. Corp. Fin., SEC, from Karrie McMillan, General Counsel, Investment Company Institute, Washington, DC, October 20, 2010 (<http://www.sec.gov/comments/s7-14-10/s71410-167.pdf>) ("ICI Comment Letter").

Many large institutional investors dispute the characterization of institutional overreliance on proxy advisory firm services. They point out that they are entitled to seek advice – as is any company – from experts of their choosing, and describe their use of the services, particularly proxy advisory firm research, as one input in a larger process. They also cite the lack of empirical evidence to support claims that institutional investors “blindly follow” the recommendations of proxy advisors. In its testimony to the House Committee on Financial Services, CII references its own study “of the largest public pension systems and institutional asset managers, [which] found that nearly all have their own proxy voting guidelines and use proxy advisory firms simply for the research; they do not vote based on the advisory firm’s voting recommendations.”<sup>31</sup> The ICI study, similarly, found that the funds studied devoted “substantial resources” to proxy voting, and made “nuanced judgments in determining how to vote on both management and shareholder proposals in order to promote the best interests of funds and their shareholders.”<sup>32</sup>

BlackRock, the world’s largest asset manager, and Vanguard Group Inc., the biggest mutual fund firm by assets, are among those institutional investors that have expressed frustration regarding the assumption of rote adherence. In June 2011, Laurence D. Fink, chairman and CEO of BlackRock, wrote a letter to 600 companies stating: “We reach our voting decisions independently of proxy advisory firms on the basis of guidelines that reflect our perspective.”<sup>33</sup> Michelle Edkins, BlackRock’s corporate governance team leader, meets with approximately 20 BlackRock analysts every morning during the proxy season to discuss how BlackRock will vote its clients’ shares. Vanguard employs about a dozen analysts to research companies year-round. Glenn Booraem, Vanguard’s principal and fund controller, says that proxy advisory firms represent only one tool for making voting decisions. “Their recommendations don’t determine where we end up,” he stated.<sup>34</sup>

The belief that institutional investors “blindly follow” proxy advisory firm recommendations, institutional investors and others point out, can have a self-fulfilling consequence, as evidence suggests that companies concerned about the influence of proxy advisory firm recommendations modify their policies and proposals to garner proxy advisory firm support. A study by The Conference Board, NASDAQ OMX Group and Stanford University’s Rock Center for Corporate Governance, for example, found that companies increasingly tailor their compensation policies—particularly incentive compensation plans, annual discretionary bonuses and severance plans and contracts—to fit within ISS’ and Glass Lewis’s standards and metrics.<sup>35</sup> In instances where a company decision can establish the basis

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<sup>31</sup> “Examining the Market Power and Impact of Proxy Advisory Firms,” Statement of Ann Yerger, Executive Director, CII, to the U.S. House of Representatives’ Committee on Financial Services: Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, p.8 (“Yerger Statement”) ([http://www.cii.org/files/publications/misc/06\\_05\\_13\\_cii\\_proxy\\_advisor\\_hearing\\_submission\\_ann\\_yerger.pdf](http://www.cii.org/files/publications/misc/06_05_13_cii_proxy_advisor_hearing_submission_ann_yerger.pdf))

<sup>32</sup> ICI Comment Letter, *supra* note 30.

<sup>33</sup> Susanne Craig, “The Giant of Shareholders, Quietly Stirring,” *New York Times*, May 18, 2013 (<http://www.nytimes.com/2013/05/19/business/blackrock-a-shareholding-giant-is-quietly-stirring.html?smid=pl-share>).

<sup>34</sup> Joann S. Lublin and Kirsten Grind, “For Proxy Advisers, Influence Wanes,” *Wall Street Journal*, May 22, 2013 (<http://online.wsj.com/article/SB10001424127887323336104578499554143793198.html>).

<sup>35</sup> The Conference Board, NASDAQ OMX Group and Stanford University’s Rock Center for Corporate Governance conducted a study that found that more than two-thirds of U.S. companies say their executive compensation program is influenced by the policies and voting recommendations of proxy voting advisors. The study also found that



for a “withhold” or “against” vote recommendation against the company’s directors, the pressure to conform to the standards and policies set forth in the ISS and Glass Lewis voting guidelines can be particularly acute.<sup>36</sup>

The influence of proxy advisory firms, whether from their recommendations, their influence on institutional investor voting policies or from corporate actions to voluntarily comply in advance with their published policies, raises concerns among many corporate governance advocates about the establishment of “one-size-fits-all” or “check the box” corporate governance rules, in an arena in which diverse corporate entities and rapid change make flexibility important. Moreover, while proxy advisory firms have the benefit of incorporating information from a broad swath of companies and other stakeholders, they do not have the ability or duty to analyze and deliberate regarding company policies that are required of corporate managers and directors. Most corporate governance advocates do not question whether proxy advisory firms have a role to play in the proxy voting process, but rather whether the current manner in which proxy advisory services are used minimizes the company-specific perspective, and replaces meaningful dialogue between institutional investors and management regarding the same. As stated in BlackRock’s 2011 letter to its portfolio companies, “Companies that focus only on gaining the support of proxy advisory firms risk forgoing valuable and necessary engagements directly with shareholders.”<sup>37</sup> Companies have, with respect to institutional investors’ use of proxy advisory firms, expressed the same.

A number of proposals have been made to address concerns with proxy advisors, including:

- adopting a code of conduct;<sup>38</sup>
- replacing the two 2004 staff no-action letters cited by Nasdaq and others as encouraging reliance on proxy advisory firm recommendations with Commission-level guidance clarifying that such reliance does not effectively fulfill institutional investors’ fiduciary duties;<sup>39</sup>

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corporate boards are likely to change CEO compensation to gain favorable say-on-pay recommendations. See Larcker, McCall, and Tayan, *supra*, note 13.

<sup>36</sup> Many companies have adopted majority voting policies in director elections, which make directors more vulnerable to a proxy advisor’s recommendation to vote against the director’s re-election.

<sup>37</sup> Craig, *supra* note 34.

<sup>38</sup> Yerger Statement *supra* note 33, at p. 4 recommending that proxy advisors (i) Register as investment advisers under the Investment Advisers Act of 1940; (i) Provide substantive rationales for vote recommendations; (iii) Minimize conflicts of interest and disclose details of potential conflicts, including those involving companies or resolution sponsors, in the applicable meeting report; (iv) Correct material errors promptly and notify affected clients as soon as practicable; and (v) Provide transparency into the general methodologies—without compromising proprietary models—used to make recommendations. See also, “Policy Briefing No. 3: Voting Integrity Practices for Investors and the Global Proxy Advisory Industry,” *Millstein Center for Corporate Governance and Performance, Yale School of Management*, 2009, Appendix A at p. 22 (<http://web.law.columbia.edu/sites/default/files/microsites/millstein-center/Voting%20Integrity%20Policy%20Briefing%20No%203%2002%2027%2009.pdf>);

<sup>39</sup> Commissioner Gallagher Speech, *supra* note 10; NASDAQ OMX, re: Petition Related to Proxy Advisory Firms, *supra*, note 2410

- clarifying that Rule 206(4) does not require all investors to vote in every corporate election;<sup>40</sup>
- ensuring that conflicts of interest are dealt with appropriately, and increasing overall accountability;<sup>41</sup>
- eliminating the exemption for proxy advisors from the proxy solicitation rules;<sup>42</sup>
- spinning off businesses that advise companies on corporate governance to avoid conflicts of interest associated with serving two different sets of clients—institutional investors and corporations;<sup>43</sup> and
- requiring evidence that corporate governance standards developed by proxy advisory firms to evaluate corporate performance have a reasonable correlation to increasing corporate value.<sup>44</sup>

Our current regulatory and political framework focuses on shareholder voting as a means to encourage accountable and effective corporate governance. Issues relating to institutional investor voting patterns and the role of proxy advisory firms in determining governance outcomes strike at the center of the perceived benefits of shareholder participation in corporate governance. Given the unabated concern expressed by corporations, the steps taken by international regulators (including Canadian regulators and ESMA) to generate transparency in the proxy advisory system, and the inarguable anomaly of the proxy advisory sector operating without any formal governance or disclosure requirements, some form of required or voluntary governance changes within the proxy advisory industry seem to be appropriate.

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<sup>40</sup> SEC rule 206(4) states explicitly that failure to vote would not necessarily mean a breach of fiduciary duties: “[w]e do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client’s best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to its client. See 17 C.F.R. § 275.206(4)-6 (2003); see also 17 C.F.R. § 270.30b1-4 (2003). Yerger Statement, *supra*, note 33, at p.4. The executive director of the Council for Institutional Investors (“CII”), an association of public, labor and corporate employee benefit funds, stated the CII view that SEC rules and interpretations do not require institutional investors to vote all proxies, but requested staff interpretive guidance to resolve acknowledged confusion about the issue.

<sup>41</sup> Commissioner Gallagher Speech, *supra* note 10.

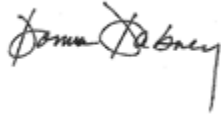
<sup>42</sup> Statement of Darla Stuckey, Senior Vice President Policy and Advocacy, Society of Corporate Secretaries and Governance Professionals to the U.S. House of Representatives’ Committee on Financial Services: Subcommittee on Capital Markets and Government Sponsored Enterprises, June 5, 2013, p. 6 (<http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-dstuckey-20130605.pdf>)

<sup>43</sup> Statement of Nell Minnow, a founder of ISS, made to the Council of Institutional Investors conference September 2013 (<http://www.pionline.com/article/20130927/DAILYREG/130929857/proxy-advisory-firms-should-split-businesses-8212-cii-speakers>)

<sup>44</sup> Larker, McCall and Tayan, *supra*, at note 19.

We appreciate the opportunity to share our research with you and we hope that it will help inform the Commission in its decisions regarding this important issue in the governance of public corporations.

Very truly yours,

A handwritten signature in dark ink, appearing to read "Donna Dabney". The signature is fluid and cursive, with the first name "Donna" written in a larger, more prominent script than the last name "Dabney".

Donna Dabney  
Executive Director  
The Conference Board Governance Center