



Filed Electronically

March 5, 2014

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549

Re: *Proxy Advisory Firms Roundtable, File No. 4-670*

Dear Ms. Murphy:

Institutional Shareholder Services (ISS), a proxy adviser registered with the Commission under the Investment Advisers Act of 1940 (Advisers Act), appreciates the opportunity to comment on the Proxy Adviser Roundtable that the Commission held on December 5, 2013. The Roundtable brought together a full spectrum of proxy voting participants -- institutional investors, proxy advisers and issuers, as well as an expert from academia -- for a thoughtful discussion of issues relating to proxy advisory services.

Perhaps the most noteworthy aspect of this discussion was the clear divide between the Roundtable participants representing investors and those representing corporate management. While the former group was generally satisfied with the services they receive from proxy advisers, the latter group was generally critical of those services. This schism suggests that proxy advisers have, themselves, become a proxy for the more fundamental question of the proper role of shareholders in corporate governance. Indeed, one of the corporate representatives at the Roundtable bluntly suggested disinvestment as an alternative to voting against management.¹ While the balance of power between those who own corporations and those who manage them may be a legitimate topic of debate, ISS submits that deflecting that debate onto proxy advisers serves no legitimate purpose.

In addition to this threshold observation, ISS addresses below a number of issues regarding proxy advisers that were discussed at the Roundtable.

¹ Remarks of Trevor Norwitz, Partner, Wachtell, Lipton, Rosen & Katz, Transcript of Proxy Advisory Firms Roundtable ("Roundtable Transcript"), available at www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt, at 66.

THE SEC DID NOT CREATE THE MARKET FOR PROXY ADVISERS

The conventional wisdom among those who disapprove of proxy advisers is that the SEC somehow bestowed inordinate market power on proxy advisers through regulation and staff guidance. This line of thinking ignores both the genesis of the proxy adviser industry and the nature of the Commission's and its staff's actions.

The History of ISS

ISS was founded in 1985 by a former employee of the U.S. Department of Labor (DOL), who soon realized that institutional investors needed high-quality proxy advice in order to fulfill their proxy-voting responsibilities on behalf of fiduciary clients. In an era of aggressive corporate practices such as raiding, greenmail and poison pills, investors were looking for a meaningful voice in corporate governance.²

Three years later, the DOL issued what has become known as the "Avon Letter" addressing the fiduciary aspects of proxy voting for employee benefit plans subject to ERISA. In so doing, the Department said:

*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.*³

A year after the Avon Letter, the DOL issued a report on the proxy voting practices of investment managers of ERISA-covered plans.⁴ In this report the Department advised that practices such as declining to vote proxies and blindly voting all proxies with management are inconsistent with the fiduciary responsibility provisions of ERISA.

In 2002, in the wake of Enron's unprecedented failure of corporate governance, then-SEC Chairman Harvey Pitt responded to a request for guidance concerning the duty of investment advisers to vote proxies on their clients' behalf.⁵ After noting the absence of direct regulation of this issue under the federal securities laws, Chairman Pitt went on to say:

² As she explained at the Roundtable, Nell Minow, Co-Founder and Board Member of GMI Ratings, was one of the earliest employees of ISS and heard these institutional investor requests, first-hand. Roundtable Transcript at 28-30.

³ Letter from Alan D. Lebowitz, Deputy Assistant Secretary to Mr. Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (February 23, 1988), 1988 ERISA LEXIS 19, *5-6.

⁴ Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989).

⁵ Letter from Harvey Pitt, SEC Chairman to John M. Higgins, President, Ram Trust Services (February 12, 2002). See also Baue, Walter, "SEC Chair Calls Proxy Voting a Fiduciary Duty" (March 29, 2002) available at: www.socialfunds.com/news/article.cgi/808.html.

We believe, however, that an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with the general antifraud provisions of the Advisers Act, as well as its fiduciary duties under federal and state law to act in the best interests of its clients.

Chairman Pitt also noted the Commission's ongoing review of various requests and proposals to address conflicts and enhance disclosure of proxy voting practices under the federal securities laws.

After completing that review, the Commission in 2003 adopted new rules and rule amendments relating to proxy voting by registered investment advisers and registered investment companies. By the time the SEC took this action, ISS was already firmly established as the leading provider of reliable, comprehensive proxy research and voting recommendations.

As it stands today, ISS is a full-service proxy adviser with more than 28 years of experience helping institutional investors make informed proxy voting decisions, manage the complex process of voting their shares, and reporting their votes to their stakeholders and regulators. ISS annually covers more than 35,000 shareholder meetings -- every holding in ISS's clients' portfolios -- in over 100 developed and emerging markets worldwide.

ISS offers a wide range of proxy voting policy options, including both standard benchmark policies focused solely on maximizing shareholder value, and specialty policies that evaluate governance issues from the perspective of sustainability, socially-responsible investing, public funds, labor unions or mission and faith-based investing. Case-by-case analytical frameworks, which take into account company size, financial performance and industry practices, drive the vast majority of ISS's vote recommendations.

ISS also makes and implements proxy voting recommendations based on a client's specific customized voting guidelines, and may assist clients in developing such custom guidelines as well. ISS implements more than 400 custom voting policies on behalf of institutional investor clients.

Except in extremely rare situations where a client has a conflict of interest and asks ISS to make a proxy voting decision on the client's behalf, ISS clients control both their voting policies and final vote decisions. They may, however, outsource the ballot processing and data management elements of their proxy voting operations to ISS. To this end, ISS often receives clients' ballots, coordinates with their custodian banks, executes votes based on client instructions, maintains voting records and provides reporting. By outsourcing these arduous administrative tasks, ISS clients are able to devote more of their internal resources to making informed voting decisions.

As a number of participants at the Roundtable explained, proxy advisers provide institutional investors with critical assistance in analyzing and synthesizing an enormous volume of information in a short period of time, thereby giving investors a meaningful voice in corporate governance while maximizing the efficient use of scarce manager resources.⁶ Since most of ISS's clientele long predates the SEC's proxy voting rules, we can say with confidence that the company's success has been driven more by a dedication to meeting investor needs than it has been by the Commission.

The Proxy Voting Rule as it Relates to Proxy Advisers

The Advisers Act proxy voting rule that the Commission adopted in 2003 applies existing fiduciary standards to the act of proxy voting, but does not create new standards.⁷ In promulgating Rule 206(4)-6, the SEC said:

*The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.*⁸

Rule 206(4)-6 applies these traditional fiduciary concepts by requiring registered investment advisers to adopt written policies and procedures reasonably designed to ensure that the adviser monitors corporate actions and votes client proxies in the clients' best interests. There seemed to be some confusion at the Roundtable as to whether the rule requires advisers to vote *every* proxy, regardless of facts and circumstances. The answer to that question is *absolutely not*.

To begin with, the rule applies only to those advisers who have explicitly or implicitly assumed voting authority over their clients' portfolios. Many small advisers, in fact,

⁶ Remarks of Michelle Edkins, Managing Director and Global Head Corporate Governance and Responsible Investment, BlackRock, Inc., Roundtable Transcript at 45-47; remarks of Damon Silvers, Director of Policy and Special Counsel, AFL-CIO, *Id.* at 63; and remarks of Eric Komitee, General Counsel, Viking Global Investors LP *Id.* at 74.

⁷ More than 50 years ago, Supreme Court construed Section 206 of the Advisers Act (the antifraud provision) as establishing a federal fiduciary standard for investment advisers. *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

⁸ Advisers Act Rel. No. 2106 (January 31, 2003) [68 Fed. Reg. 6585, 6586] (Feb 7, 2003) ("Proxy Rule Release") (citations omitted). In addition to the Advisers Act rule, the Commission also adopted various rule and form amendments designed to increase public disclosure of how registered investment companies vote proxies relating to the portfolio securities they hold. Investment Company Act Rel. No. 25922 (January 31, 2003) [68 Fed. Reg. 6564] (February 7, 2003).

disclaim such authority. Even where an adviser assumes such authority, the obligation to vote any particular proxy depends on facts and circumstances. In the Commission's words:

*We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.*⁹

In addition to requiring an adviser to adopt proxy voting policies and procedures, the rule also requires the adviser to describe those policies and procedures to clients, and to provide a copy of them upon a client's request. Finally, the rule obliges the adviser to tell clients how they can obtain information about how their securities were voted.

Because the fiduciary duty of loyalty requires advisers to act in their clients' best interests, the Commission, in adopting Rule 206(4)-6, paid special attention to the ways in which advisers could manage conflicts of interest that might arise in the proxy voting process:

Advisers today use various means of ensuring that proxy votes are voted in their clients' best interests and not affected by the advisers' conflicts of interest. An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser. Similarly, 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. An adviser could also suggest that the client engage another party to determine how the proxies should be voted, which would relieve the adviser of the responsibility to vote the proxies. Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and

*procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.*¹⁰

The Commission's recognition that advisers can mitigate conflicts of interest in proxy voting by seeking the advice of an independent third party was hardly radical, since the same approach is widely utilized in other areas of investment management.¹¹

⁹ Proxy Rule Release, 68 Fed. Reg. at 6587 (citations omitted).

¹⁰ *Id.* 68 Fed. Reg. at 6588 (citations omitted).

¹¹ See e.g., Remarks of Karen Barr, General Counsel, Investment Adviser Association, Roundtable Transcript at 57 ("Outsourcing is perfectly acceptable. It's perfectly acceptable to delegate duties to a

The Staff Interpretive Guidance

This recognition by the Commission gave rise to routine interpretive guidance that has been thoroughly mischaracterized by those who wish to limit the use of proxy advisory services.

Approximately a year after Rule 206(4)-7 was adopted, an unregistered proxy adviser approached the staff of the SEC's Division of Investment Management seeking guidance about the meaning of the term "independent third party" as used in the rule's adopting release. After generally discussing the types of conflicts an adviser could face in voting clients' proxies, the staff explained that a third party's independence depends on its relationship to the adviser.¹² An investment adviser that retains a third party to make proxy voting recommendations must 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.

However, the staff went on to explain that merely determining the independence of the third party is not enough. Because the investment adviser is a fiduciary, the adviser has a duty to scrutinize the independent third party's "competency to adequately analyze proxy issues" and to make "recommendations in an impartial manner and in the best interests of the adviser's clients."¹³ The staff indicated that such due diligence is not a one-time exercise, but must be undertaken on an ongoing basis, for example, by a case-by-case evaluation of the third party's own conflicts of interest.

In a subsequent letter to ISS, the staff gave additional guidance on the type of due diligence an adviser must conduct to satisfy its fiduciary duty when seeking proxy voting advice from an independent third party.¹⁴ In this regard, the staff explained:

Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should

third party. Investment advisers do it all the time, They hire, for example, sub-advisers to manage parts of their portfolio's core asset management duties, but what advisers do is retain the ultimate fiduciary responsibility to select those third parties. . . and then [exercise ongoing] oversight . . ."). See also remarks of Eric Komitee, Roundtable Transcript at 73 ("[I]f we have a conflict of interest potentially with respect to the valuation of a given position, we may go get advice from a third party valuation firm because we believe that the valuation decision we make will be less subject to criticism once we have looked to the expertise of a third party that is . . . intended to think about those issues").

¹² Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management to Kent S. Hughes, Egan Jones Proxy Services (May 27, 2004).

¹³ *Id.*

¹⁴ Institutional Shareholder Services Inc., 2004 SEC No-Act. LEXIS 736 (September 15, 2004). At the Roundtable, this letter was repeatedly characterized as a "no-action letter." However, the staff made it clear that it was not issuing such a letter, since ISS did not request relief from any requirement of Rule 206(4)-7. See note 2.

take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process. . . . An investment adviser should have a thorough understanding of the proxy voting firm's business and the nature of the conflicts of interest that the business presents, and should assess whether the firm's conflict procedures negate the conflicts.¹⁵

The staff went on to say that because a proxy advisory firm's business and/or conflict procedures could change over time, the investment adviser has a fiduciary duty to monitor the third-party service provider's independence on an ongoing basis.

As Karen Barr of the Investment Advisers Association, explained at the Roundtable, these staff interpretive letters did not make it easier for investment advisers to rely on third-party proxy advice. In fact, they did just the opposite, by spelling out the extensive and ongoing due diligence required of advisers who use these services.¹⁶

Although some of the corporate representatives at the Roundtable questioned the propriety of an investment adviser's conducting a comprehensive examination of a proxy advisory service's conflict of interest policies and procedures in lieu of evaluating their conflicts on a vote-by-vote basis, macro-level analysis is the standard method investment advisers use to conduct due diligence.¹⁷ For example, an adviser who mitigates its conflicts regarding portfolio valuation by relying on the expertise of an independent valuation service typically assesses the service's integrity and competence by examining the service's overall policies, procedures and operations, and not by evaluating its conflicts on a security-by-security or price-by-price basis.

As with rule itself, the staff's interpretive guidance regarding Rule 206(4)-6 did not create the market for proxy advisory services.¹⁸

¹⁵ *Id.* at *4-5.

¹⁶ Roundtable Transcript at 58-59.

¹⁷ See Lorna A. Schnase, *An Adviser's Duty to Supervise Sub-Advisers (and Other Advisers)* 18-22 (2012) (noting that initial due diligence of outsourced advisory services should include matters such as a review of the third party's compliance systems, code of ethics, internal procedures, Form ADV disclosures and other information about the party's qualifications to perform in the capacity contemplated. On an ongoing basis, due diligence could include quarterly or annual certifications of compliance with applicable laws and the third party's policies and procedures, periodic meetings with key personnel, confirmation of ADV disclosures and notification of material changes to information previously supplied).

¹⁸ See remarks of Karen Barr, Roundtable Transcript at 58 ("[IAA] members' experience is not that they've increased their use of proxy advisory firms because of the no-action letters. They've increased the use because of the complexity and number of votes"); and remarks of Eric Komitee, *Id.* at 72-75. (noting that with or without the staff letters, advisers have a fiduciary duty to vote proxies as a matter of good

INVESTMENT ADVISERS DO NOT OUTSOURCE THEIR FIDUCIARY RESPONSIBILITIES OR BLINDLY FOLLOW THE RECOMMENDATIONS OF PROXY ADVISORY SERVICES

It was clear from the Roundtable discussion that money managers do NOT outsource their fiduciary duties by blindly following whatever proxy advisers recommend.

As a starting point we note that in adopting the Advisers Act proxy Rule, the Commission expressly stated that:

[n]othing in this rule reduces or alters any fiduciary obligation applicable to any investment adviser (or person associated [therewith]).¹⁹

This was similar to the position DOL took 15 years earlier in the Avon Letter:

ERISA contains no provision which would relieve an investment manager of fiduciary liability for any decision he made at the direction of another person. . . . Therefore, . . . to the extent that anyone purports to delegate to another the responsibility for such voting decisions, the manager would not be relieved of its own responsibilities and related liabilities merely because it either follows the direction of some other person or has delegated the responsibility to some other person.²⁰

As discussed above, the SEC staff guidance on the use of proxy advisory services also emphasized that investment advisers retain the fiduciary obligation to vote proxies in the best interests of their clients and must monitor and evaluate independent proxy services on an ongoing basis.

It was made abundantly clear that hiring a proxy adviser is not a "safe harbor" from fiduciary duty in a 2009 SEC enforcement action in which the Commission sanctioned a registered investment adviser for voting all of its clients' proxies in accordance with third-party proxy guidelines that were not in the best interests of some of its clients.²¹

corporate citizenship, and that relying on the assistance of outside parties is a common way of addressing conflicts of interest.)

¹⁹ Proxy Rule Release, note 8. Even former SEC Chairman Harvey Pitt, a vocal opponent of proxy advisers, admitted that "the purpose of the rule wasn't to change fiduciary duties or law. It was to make people sensitive to fiduciary duties and what their obligations were." Roundtable Transcript at 89.

²⁰ Avon Letter, 1988 ERISA LEXIS 19,*8.

²¹ *In the Matter of INTECH Investment Management LLC and David E. Hurley*, Advisers Act Release No. 2872 (May 7, 2009). In finding a violation of Advisers Act Section 206 and Rule 206(4)-6, the Commission noted that the adviser's choice of voting guidelines was tainted by a conflict of interest, because the adviser chose guidelines that could help it retain and obtain advisory business notwithstanding the fact that those guidelines were unsuitable for certain clients.

It was evident from the testimony presented at the Roundtable that improper use of proxy advisers is the exception rather than the rule. In general, institutional investors take their fiduciary responsibilities regarding proxy voting very seriously and understand their ongoing duty to vote proxies in their clients' and beneficiaries' best interests. For many large investors, proxy advisers' research and vote recommendations are just one source of information used in arriving at the institutions' voting decisions.²² Many investors have internal research teams that conduct proprietary research and use proxy advisory research to supplement their own work.²³ Some investors use third-party proxy research as a screening tool to identify non-routine meetings or proposals. A number of institutional investors use the services of two or more proxy advisory services. The first-hand experience described by witnesses at the Roundtable was echoed by Karen Barr of the Investment Adviser Association. Ms. Barr also noted that although some small investment advisers may rely on proxy advisers more extensively than large advisers with dedicated research staff of their own, thousands of small firms do not use proxy advisers at all.²⁴

In addition to showing respect for their fiduciary duties, the participants representing investors at the Roundtable uniformly rejected the idea that they blindly take direction from proxy advisers.²⁵

Further, while Mark Chen, Associate Professor of Finance, Georgia State

²² Remarks of Michelle Edkins, Roundtable Transcript at 45 ("BlackRock typically uses research and other data services from proxy advisory firms as one of many inputs in our proxy voting decisions We use the firms primarily to synthesize the vast array of data that you get in proxy statements, and more than just synthesize it, to put it in a consistent format").

²³ Remarks of Anne Sheehan, Director of Corporate Governance, CalSTRS, *Id.* at 153-54; remarks of Lynn Turner, Managing Director, LitiNomics, Inc., discussing his experience at Colorado PERRA, *Id.* at 51-52.

²⁴ *Id.* at 56.

The views expressed at the Roundtable are consistent with the results of a recent survey of asset managers by Tapestry Networks that found proxy advisory firms' "role as data aggregators" has become increasingly important to asset managers. Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: <http://ssrn.com/abstract=2084231>. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

²⁵ See, e.g, remarks of Michelle Edkins, *Id.* at 50 (for "say on pay votes" in 2012, BlackRock voted against four percent of the proposals, while their proxy advisers recommended no votes on roughly 16 percent of the proposals); remarks of Lynn Turner, *Id.* at 53 (CoPERRA voted against Glass Lewis's director recommendations 52 percent of the time; "Glass Lewis actually voted with management a lot more often than we did."); remarks of Eric Komitee, *Id.* at 75 ("there are certainly times where we disagree with the proxy advisory services"). See also *Id.* at 153.

University, noted a high correlation between proxy advice and vote outcomes, he was unable to state whether that correlation derives from large investors' outsourcing their voting decisions to proxy advisers or from the fact that voting advice brings important new information to the markets.²⁶

This latter view has been endorsed by other academics. In their paper, *The Power of Proxy Advisors: Myth or Reality?*,²⁷ University of Pennsylvania Law School Professor Jill Fisch, along with colleagues from New York University analyzed the effect of proxy adviser recommendations on voting outcomes in uncontested director elections. The authors estimate that, after controlling for underlying company-specific factors that influence voting outcomes, an ISS recommendation appears to shift 6 to 10 percent of shareholder votes, but that this influence may stem from ISS's role as information agent:

*[W]e find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms. Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences.*²⁸

The investor representatives participating at the Roundtable had their own theories about the correlation between proxy adviser vote recommendations and actual votes cast. Lynn Turner conveyed that the large institutional investors and proxy advisers have common views about corporate governance.²⁹ Eric Komitee agreed.³⁰ Damon Silvers observed that the SEC and the DOL would likely be concerned if institutional investors were spending money on proxy advisory services they found to be of no value.³¹

Of course, another reason for the correlation between recommendations and votes

²⁶ *Id.* at 39-41.

²⁷ Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, *The Power of Proxy Advisors: Myth or Reality?* 59 *Emory L. J.* 869 (2010); University of Pennsylvania, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: <http://ssrn.com/abstract=1694535>.

²⁸ *Id.* at 906.

²⁹ Roundtable Transcript at 54.

³⁰ *Id.* at 152-53 (I think it's possible . . . that a lot of the statistics that show a correlation between their recommendations and the outcome of a vote are because the ultimate voters . . . think in the same way that the proxy advisory services do about director performance and other similar subjects, not because we're voting blindly with them and not because we're even necessarily persuaded by their reasoning so much as just because we happen to think that way to begin with").

³¹ *Id.* at 63.

cast is that in many instances, proxy advisers base recommendations to their clients on the clients' own custom voting policies.

THERE IS AN EFFECTIVE REGULATORY REGIME FOR PROXY ADVISERS

One of the corporate management representatives at the Roundtable characterized proxy advisers as “unaccountable” and “unregulated,”³² and questions have been raised about the need for a new regulatory regime designed specifically for proxy advisers. The fact is that since 1997, ISS has been registered with the SEC under the Advisers Act, a regulatory regime that is very well equipped to deal with proxy advisory issues.

An “investment adviser” under this statute is not synonymous with asset manager. Instead, an investment adviser is any person who, for compensation and as part of a regular business, advises others about the value of securities or whether to buy or sell securities, or who issues reports or analyses about securities.³³

In its 2010 Concept Release on the U.S. Proxy System, the SEC explained the applicability of the Advisers Act to proxy advisers as follows:

[P]roxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote at shareholder meetings. . . . We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to maximize the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.³⁴

While some aspects of the investment adviser regulatory regime are directed exclusively at asset managers, many of the regime's core requirements apply with equal force to managers and research-oriented firms like proxy advisers. In this regard, the Advisers Act and related rules oblige proxy advisers to:

- implement a Code of Ethics;
- designate a Chief Compliance Officer;

³² Remarks of Trevor Norwitz, *Id.* at 35.

³³ Advisers Act Section 202(a)(11) [15 USC 80b-2(a)(11)].

³⁴ Concept Release on the U.S. Proxy System, SEC Rel. No. IA-3052 (July 14, 2010) at 109-110, 75 Fed Reg. 42981, 43010 (July 22, 2010).

- adopt a comprehensive set of compliance procedures -- including procedures relating to proxy voting -- reasonably designed to prevent, detect and correct violations of the Advisers Act and to mitigate conflicts;
- at least annually assess the sufficiency of the compliance procedures and the effectiveness of their implementation;
- maintain a comprehensive set of books and records;
- make full disclosure to clients and prospective clients about the adviser's business and any potential conflicts of interest related thereto.

Applying the Advisers Act regulatory regime to proxy advisers is particularly fitting, since so many of their clients are registered under that regime. Investor interests are best protected when proxy advisers are subject to the same fiduciary standards as the asset managers they serve. ISS submits that all proxy advisory services should be subject to the Advisers Act's extensive conflict management and disclosure requirements. That is the ultimate form of accountability.

PROXY ADVISERS EFFECTIVELY MANAGE AND DISCLOSE THEIR CONFLICTS OF INTEREST

A corollary to the myth that proxy advisers are unregulated and unaccountable is the myth that they do not effectively manage and disclose their conflicts of interest. As a registered investment adviser, ISS has a legal duty either to eliminate or manage and disclose its conflicts. ISS satisfies this duty in a number of ways.

ISS addresses conflicts, first and foremost, by being a transparent, policy-based organization. Its use of a series of published voting policies provides a very practical check and balance that ensures the integrity and independence of ISS's analyses and vote recommendations. While these policies allow analysts to consider company- and market-specific factors in generating vote recommendations, the existence of a published analytical framework, coupled with the fact that vote recommendations are based on publicly-available information, allows ISS clients to continuously monitor the integrity of ISS advice.³⁵

Furthermore, pursuant to its obligations under the Advisers Act, ISS has undertaken a comprehensive risk assessment to identify specific conflicts of interest related to its operations and has adopted compliance controls reasonably designed to manage those risks. One of the primary components of its compliance program is a Code of Ethics that prescribes standards of conduct for ISS and its employees.

The Code of Ethics affirms ISS's fiduciary relationship with its clients and obligates ISS and its employees to carry out their duties solely in the best interests of clients and free from any compromising influences and loyalties. The Code also contains restrictions on personal trading designed to prevent employees from improperly trading on, or

³⁵ Each ISS analysis includes a URL for a direct hyperlink to ISS's summary voting guidelines for easy access by users of our research.

benefiting from, inside information, client information and/or ISS's voting recommendations. The Code emphasizes the requirement that all research for clients be rendered independently of employees' personal interests.

In order to ensure compliance with the Code of Ethics, ISS conducts periodic training sessions for employees and requires employees to affirm their commitment to compliance on an annual basis. Furthermore, ISS regularly monitors the sufficiency of the Code and the effectiveness of its implementation.

- **Conflicts in Connection with Affiliated Corporate Services**

The most talked-about conflict where ISS is concerned relates to the fact that one of its affiliates, ISS Corporate Services, Inc. ("ICS"), provides governance tools and services to issuer clients. Left unchecked, this conflict could result in vote recommendations that are biased in favor of corporate management. Given the fact that the most vocal critics of ISS are the corporations and not the institutions who rely on ISS vote recommendations, it appears that the company is managing this potential conflict extremely well.

One of the most important components of the ISS compliance program is the firewall maintained between the core institutional business and the ICS business. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning the identity of ICS's clients, thereby ensuring the objectivity and independence of ISS's research process and vote recommendations. The firewall mitigates potential conflicts via several layers of separation:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- ISS Global Research team works independently from ICS.
- ICS and ISS staff are forbidden to discuss the identity of ICS clients.
- Institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.
- ICS explicitly tells its corporate clients and indicates in their contracts that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. ICS further informs its clients that ISS's Global Research team prepares its analyses and vote recommendations independently of, and with no involvement from, ICS.

As is the case with the Code of Ethics, ISS maintains a robust training and monitoring program regarding the firewall. This program includes quarterly tests of the firewall's integrity, new-hire orientation, and review of certain marketing materials and disclosures. There also is an ethics hotline available to both ICS and ISS staff for reporting issues of potential concern.

- **Conflicts in Connection with ISS's Parent Company**

In addition to managing conflicts arising from the corporate advisory services of its ICS affiliate, steps have been taken to protect ISS's independence from its ultimate parent corporation, MSCI Inc. First, ISS recuses itself from making voting recommendations regarding MSCI proxy issues, and instead supplies clients with the analyses of multiple other proxy advisory firms to inform their vote decision. Furthermore, the MSCI Board of Directors has adopted resolutions stating that: (i) the formulation, development and application of ISS's proxy voting policies (including the establishment of voting standards), proxy analyses and vote recommendations are and shall remain the sole responsibility of ISS at all times; (ii) the non-executive members of the MSCI Board of Directors shall have no role in formulating, developing or implementing ISS's proxy voting policies, proxy analyses and/or vote recommendations; and (iii) the non-executive members of the MSCI Board of Directors shall not be informed of the content of any ISS proxy analyses or vote recommendations prior to their publication or dissemination.

The MSCI Inc. Board of Directors also has adopted a Conflicts of Interest Policy related to "Director Affiliated Companies" to address any potential conflicts of interest posed by other public company board seats held by any MSCI Inc. director.

- **Conflicts Within the Institutional Advisory Business**

Conflicts also may arise where an ISS client is, itself, a public company whose proxies are the subject of analyses and voting recommendations, or other advisory research report, or where the Company is called upon to analyze and vote on shareholder proposals propounded by a Company client. ISS's fiduciary commitment to act in the best interests of each client, its practice of aligning vote recommendations with applicable published or custom voting policies, and the ongoing scrutiny it receives from its institutional clientele effectively address this potential conflict.

- **Conflicts in Connection with Issuers' Review of Draft Analyses**

If, upon reviewing a draft proxy vote analysis, an issuer notifies ISS in writing of one or more factual inaccuracies in the draft, an ISS analyst may decide to change his or her proposed voting recommendation. In order to ensure the propriety of the interaction between the issuer and the analyst, the analyst's decision to change the vote recommendation must be reviewed by a senior analyst and appropriate records must be kept of the communication from the issuer and the voting decision. These records are subject to the Chief Compliance Officer's periodic review.

- **The "Skin in the Game" Conflict**

Perhaps the best evidence that proxy advisers are in a no-win situation is the fact that the same parties who criticize them for having conflicts of interest also criticize them for not having "skin in the game."³⁶ As the SEC has long recognized, owning the

³⁶ See, e.g., remarks of Trevor Norwitz, *Id.* at 35, 101 and 146.

securities that are the subject of investment advice is a conflict of interest. Thus, a portfolio manager who has a proprietary interest in securities it recommends to clients must disclose that fact,³⁷ and must adopt policies and procedures reasonably designed to manage the conflict. Since one of the ways portfolio managers can address conflicts in the proxy voting area is by relying on the advice of an independent third party, encouraging proxy advisers to take their own proprietary positions in the securities that are the subject of their advice is an extremely bad idea.

This is especially true in light of the fact that ISS makes vote recommendations in accordance with standard voting policies, specialized voting policies and more than 400 custom voting policies. Some of the clients it serves are long-term investors, some are short-term investors, and some invest according to environmental, social, faith-based or other philosophies. ISS already has a fiduciary duty to make recommendations in the best interests of each of its clients. Maintaining a proprietary securities portfolio would do nothing to advance ISS's clients' interests.

- **The Improved Services Conflict**

One of the corporate representatives at the Roundtable identified a novel conflict that, for want of a better term, ISS will call the "improved services" conflict. The idea here seems to be that proxy advisers have a conflict of interest whenever they enhance their services because doing so helps them retain or attract institutional clients.³⁸ Not surprisingly, institutional investors do not share this view and consider service enhancements to be a good thing.³⁹

- **Disclosure Regarding Potential Conflicts**

ISS provides its investor clients with an extensive array of information to ensure that they are fully informed of potential conflicts and the steps ISS has taken to address them. In addition to making full disclosure in the Form ADV brochure it delivers to each client, ISS supplies a comprehensive due diligence compliance package on its web site to assist clients and prospective clients in fulfilling their own obligations regarding the use of proxy advisory services. This package includes a copy of ISS's Code of Ethics, a description of other policies, procedures and practices regarding potential conflicts of interest and a description of the ICS business. A copy of the MSCI Board of Directors Conflicts of

³⁷ See, e.g., Form ADV, Part 1A, Item 8 and Part 2A, Item 11.

³⁸ Remarks of Trevor Norwitz, Roundtable Transcript at 104.

³⁹ Remarks of Anne Sheehan, *Id.* at 105-06 ("I don't see that at all [as] a conflict. I see it as part of the free market and trying to improve the product that we, the customers, want to buy. Many times it's we, the customers, who are asking them to do these additional services for us . . ."); see also remarks of Michelle Edkins, *Id.* at 51 ("[W]e look at performance enhancements that we would like to see in the coming year. We have been . . . partnering with [ISS] as our primary service provider for many, many years[;] in that way to try and keep things evolving because I think we all recognize there's always room for improvement").

Interest Policy related to Director-Affiliated Companies is also available through the ISS web site.

Moreover, each proxy analysis and research report ISS issues contains a legend indicating that the subject of the analysis or report may be a client of or affiliated with a client of ISS, ICS or another MSCI subsidiary. Each analysis and report also notes that one or more proponents of a shareholder proposal may be a client of ISS or one of its affiliates, or may be affiliated with such a party. Although investment advisers typically disclose conflict of interest information at a macro level,⁴⁰ ISS does more. Any client that wishes to learn more about the relationship, if any, between ICS and the subject of a particular analysis or report may contact ISS's Legal and Compliance Department for relevant details. This process allows ISS's proxy voting clients to receive the names of ICS clients without revealing that information to research analysts as they prepare vote recommendations and other research. Were the ICS relationship identified on the face of a proxy analysis or report, this critical information barrier would be destroyed.

In addition to obtaining report-by-report conflict information, institutional clients of ISS can obtain lists of all ICS clients. As I explained at the Roundtable, some clients receive such lists on a monthly basis, while others receive the lists on a quarterly or annual basis.⁴¹ This is just one of the many steps institutional investors take to reassure themselves that ISS is appropriately mitigating conflicts. They also obtain a range of additional information regarding our information barriers, our data centers, and other aspects of our operations. Many clients meet with ISS staff to discuss conflicts and other issues on an annual basis.

ISS remains committed to managing its conflicts of interest and to working with its institutional clients to ensure their continued trust and confidence in our services.

PROXY ADVISORY SERVICES ARE TRANSPARENT AND ACCURATE

Transparency

Another area of disagreement between the corporate management and investor representatives at the Roundtable concerned the transparency of proxy advisory services. Notwithstanding some generalized complaints in this area from the management participants, it was clear from the discussion that ISS is committed to formulating its proxy voting policies and guidelines in a transparent manner.

Each year, the policy-setting process begins with a Policy Survey seeking input from both institutional investors and corporate issuers in an effort to identify emerging issues that merit attention prior to the upcoming proxy season.⁴² Based on this

⁴⁰ See, e.g. Form ADV, Part 2A, Item 11.

⁴¹ Roundtable Transcript at 89-90, 110-11.

⁴² In 2013, ISS received survey responses from over 500 parties, including 130 institutions and about 350 corporations, and trade groups, such as the Business Roundtable, the Center on Executive

feedback, ISS convenes a series of roundtables with various industry groups and outside issue experts to gather multiple perspectives on complex or contentious issues. As part of this process, ISS researchers examine academic literature, other empirical research and relevant commentary in an effort to uncover potential links between an issue and financial returns and/or risk.

The ISS Global Policy Board, which is comprised of ISS's market research heads and internal subject matter experts, uses this input to develop its draft policy updates. Before finalizing these updates, ISS publishes them for an open review and comment period (modeled on the SEC's process for commenting on pending rule-making). This open comment period is designed to elicit objective, specific feedback from investors, corporate issuers and industry constituents on the practical implementation of proposed policies. For the past several years, all comments received by ISS have been posted verbatim to the ISS Policy Gateway on its public website, in order to provide additional transparency into the feedback we have received. Final updates are published in November, to apply to meetings held after February of the following year. In addition to the Global Policy Board, ISS also has established a Feedback Review Board, chaired by me as ISS' President, to provide an additional conduit for investors, executives, directors and other market constituents to communicate with ISS.

ISS's outreach is not confined to the policy-setting process. Robust engagement is an essential part of our day-to-day operations. Each season, ISS engages with thousands of corporate executives, board members, institutional investors and other constituents via in-person meetings, conference calls and participation in industry events. The purpose of such engagement is for ISS to obtain, or communicate clarification about governance and voting issues, in order to ensure that our research and policy-driven recommendations are based on the most comprehensive and accurate information available. Sometimes these conversations are initiated by ISS, and sometimes they are initiated by the issuer or shareholder. In contested situations, ISS ordinarily engages with both sides.

Questions were raised at the Roundtable about the transparency of proxy advisers' communications with issuers, investors and other interested parties. As I mentioned in my remarks, notwithstanding our willingness to hear from all sides, ISS bases its vote recommendations exclusively on public information.⁴³ Furthermore, insights ISS gleans from communications with interested parties are reflected in our proxy advisory reports if ISS deems such information to be useful in helping institutional clients make more informed voting decisions. In some cases, ISS may include direct quotations from statements made by participants in the meeting(s). At the discretion of the analyst, a brief "engagement summary" may be included on the front page of the analysis report.

ISS looks forward to continuing its practice of comprehensive engagement on issues of corporate governance while always being mindful of the fact that we owe our fiduciary obligations to investors.

Accuracy

The only concern about the quality or accuracy of proxy advisory services expressed at the Roundtable came from corporate representatives in the form of a few anecdotes about errors in specific proxy reports. The fact is that ISS goes to great lengths to ensure that its proxy reports are complete and materially accurate. ISS has a myriad of policies and procedures to ensure the integrity of its research process. As explained above, ISS's analyses and recommendations are driven by publicly disclosed and detailed policy guidelines in order to ensure consistency and to eliminate potential analyst implementation bias.

Furthermore, prior to delivery to clients, each proxy analysis undergoes a rigorous internal review for accuracy and to ensure that the relevant voting policy has been applied. In the U.S., companies found in the Standard & Poor's 500 Index generally receive an opportunity to review a draft analysis for factual accuracy prior to delivery of the analysis, and ISS reviews other requests for review and comment on a case-by-case basis. All issuers may request and receive a free copy of the published ISS analysis of its shareholder meeting.

While issuer representatives at the Roundtable expressed a desire for more time to review draft proxy reports,⁴⁴ it was clear from the discussion that the current configuration of the proxy season places time constraints on corporations and advisory services alike. As I noted in my remarks, proxy advisers are doubly constrained, limited on one side by the time the proxy is filed, and on the other side, by the time investors need to analyze our research and recommendations and arrive at their voting decisions.⁴⁵

ISS's commitment to quality is further shown by the fact that it conducts periodic SAS-70/SSAE 16 audits to ensure compliance with its internal control processes, including its research process. ISS believes that these audits reduce the chance that an analysis will be published with material errors and provide a correction mechanism after a report has been delivered. Finally, although some participants at the Roundtable expressed concern about concentration in the market for proxy advisory services, at least one institutional investor conveyed that not only does market competition exist, it also improves the quality of these services.⁴⁶

⁴⁴ Roundtable Transcript at 140.

⁴⁵ *Id.* at 141.

⁴⁶ Remarks of Anne Sheehan, *Id.* at 155 ("I think the competition has helped improve the quality because they keep [ISS and Glass Lewis] on their toes in terms of who does better. And I think as Nell [Minnow] said, this is a market situation. Let the market decide, and that competition has really improved it").

While ISS strives to be as accurate as possible, the research team does, infrequently, identify material factual errors in our reports, such as those relating to the agenda, data or research/policy application. When this happens, the research team promptly issues a "Proxy Alert" ("Alert") to inform clients of any corrections and, if necessary, vote recommendation changes. Alerts are distributed to ISS's institutional clients through the same ProxyExchange platform used to distribute our regular proxy analyses. This ensures that the clients who received an original analysis will also receive the related Alert, which is attached to the company meeting. During the 2012 calendar year, ISS delivered Alerts for 537 (1.5 percent) of more than 35,000 meetings covered around the globe. For the U.S. market, the 2012 correction rate was 2.3 percent (152 of 6,532 meetings).

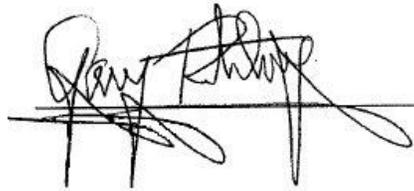
ISS acknowledges that corporate issuers do not always agree with our vote recommendations. This is understandable given that these recommendations are not always aligned with those of a company's management and board. The interests of a company's owners can and do conflict with those of management and the board from time to time. ISS would not be serving its investor clients if it did not highlight these cases. ISS notes, however, that when issuers dispute our analyses, the disputes generally relate to policy application (or the principles underlying the policies themselves), not the factual accuracy of the analysis.⁴⁷ ISS remains committed to working with governance stakeholders to ensure the quality of our proxy advisory services.

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⁴⁷ As Anne Sheehan of CalSTRS observed: "What I have found, that many times the errors are really differences of opinion." *Id.*

ISS is pleased to have had the opportunity participate in the Roundtable on Proxy Advisory Firms and appreciates the opportunity to submit these follow-up comments. We would be happy to supply the Commission or the staff with additional information regarding any of the matters discussed herein. Please direct questions about these comments to the undersigned or to our outside counsel, Mari-Anne Pisarri. She can be reached at 202.223.4418.

Very truly yours,

A handwritten signature in black ink, appearing to read "Gary Retelny", written over a horizontal line. The signature is stylized and cursive.

Gary Retelny
President

cc: Hon. Mary Jo White
Hon. Luis A. Aguilar
Hon. Daniel M. Gallagher
Hon. Kara M. Stein
Hon. Michael S. Piwowar
Norm Champ
Keith F. Higgins