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THE GOVERNANCE CENTER

October 20, 2010

By E-Mail

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

Re: File Number S7-14-10; Concept Release on the U.S. Proxy System

Dear Ms. Murphy:

We, as members of the McKenna Long & Aldridge Governance Center, provide corporate governance advice to public companies and their boards of directors in conjunction with their interface with their shareholders and proxy advisory firms. In connection with the Securities and Exchange Commission's Concept Release on the U.S. Proxy System, issued July 14, 2010 (the "Concept Release"), we provide the following comments on a specific issue of critical importance: The need to ensure meaningful dialogue between companies and their shareholders on corporate governance issues. We base these comments on our own experience in providing corporate governance counseling, as well as our informal survey of a number of Fortune 150 companies across a broad spectrum of industries.

Corporate governance is now recognized as an important shareholder value component. But while corporate governance philosophies and practices have evolved substantially in the past twenty years, the required quality and consistency of dialogue between companies and their owners to assure informed corporate governance decisions has not developed. Whereas discussions between companies and shareholders regarding financial and operational performance occur on an ongoing basis via the investor relations (IR) process, specific corporate governance issues are too often not part of this regular exchange.[1]

[1] Indeed, the current proxy-driven approach to corporate governance evaluation is a function of, and in turn perpetuates, the dynamics that (1) the average retail investor is not directly engaged in the corporate governance debate; and (2) the intermediaries to whom they have entrusted this function too often rely on quantitative analysis produced on a volume, one-size-fits-all business basis, either by an in-house division or by so-called proxy advisory firms.

Addressing the need to move corporate governance dialogue beyond the annual meeting and proxy process into meaningful ongoing dialogue between shareholders and companies, we discuss below the desirability of moving corporate governance evaluations into the traditional investor relations process of dialogue between companies and their shareholders where the accuracy of data, and the review of it in the context of a total business model, is part of meaningful in-person discussions between the parties. We note not only the recent rise of governance as a shareholder value concern, but also the countervailing failure of companies and shareholders to bring governance into the traditional investor relations discussions. Indeed, as outlined below, we believe that the investor relations approach is an appropriate model for facilitating shareholder dialogue on corporate governance issues and that, with appropriate reforms at both the proxy advisory firms and institutional shareholders, the proxy advisory firms can play a critical role without conflicts in facilitating direct dialogue between companies and shareholders.

I. Corporate Governance Should Be Part of Ongoing Shareholder Dialogue and Not Confined to the Annual Meeting and Proxy Process

When the concept of a fictional legal entity – a corporation – was originally established in the United States, there generally were only a limited number of shareholders with respect to any single corporation, and these shareholders usually were integrally involved in the operations of the corporation.[2] Accordingly, there was active communication between shareholders and those individuals they selected, if not themselves, to run the company. With this structure, corporate governance as it is conceived today was generally not regarded as a component of a company's business model because the shareholders effectively operated the company.

As the corporation evolved and shares became publicly traded and held by a diverse, disconnected group of investors separate from management (i.e., senior executives and directors), management became the dominant influence on the corporation.[3] The IR function was adopted at most public companies as the company's process for providing accountability to shareholders and has been embraced by shareholders as their window into the operations of companies. The IR function historically has meant regular meetings among the company, investors and portfolio analysts to provide a forum for dialogue on issues and concerns with respect to current and future company performance, as well as to provide investors and portfolio analysts with general or strategic information about the company.[4] While historically the focus

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[2] R. Franklin Balotti, Jesse A. Finkelstein & Gregory P. Williams, Meetings of Stockholders § 5.2 (2009).

[3] *Id.*

[4] The IR function is especially active after a public company issues its earnings report and a press release explaining its earnings. Shortly thereafter, the IR function engages in direct discussions with shareholders (and their advisers) and portfolio analysts to discuss the earnings reports (respecting the regulatory parameters of Regulation Fair Disclosure). The IR function also actively participates in investor conferences where company performance is

has been on financial metrics and related performance measures, with globalization and the growing complexity of business and financial operations, discussions have expanded into risks and more qualitative analysis. Nonetheless, even with the adoption of the IR function at most public companies, corporate governance rarely was discussed. Corporate governance was not viewed as a critical component of a company's business model or related financial performance.

The passage of the Sarbanes Oxley Act in 2002 and the Dodd–Frank Wall Street Reform and Consumer Protection Act in 2010, plus the multitude of other federal and state legislation, regulations and judicial decisions,[5] make it clear that corporate governance is now viewed as a critical component of company performance and, therefore, shareholder value. Nonetheless, the relationship between companies and shareholders – their owners – has become attenuated because corporate governance analysis and discussions have evolved outside of, and independently from, the IR process. Absent the annual meeting and related discussions, the focus of discussions between companies and shareholders continue to be about financial performance and related metrics with little, if any, attention demanded by shareholders or offered by companies as part of the IR process regarding corporate governance.[6]

We submit that governance evaluations should not be confined to the annual proxy process, where myriad investor policies and procedures designed around proxy review may limit opportunities for substantive dialogue. Rather, corporate governance discussion should follow the IR model, where quarterly earnings calls, the general availability of IR personnel, and related

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discussed with a multitude of constituencies in even more detail. As the foregoing reflects, the IR function allows companies and shareholders to transform otherwise quantitative earnings reports into qualitative analysis about company performance.

[5] In re Caremark Intern. Inc. Derivative Litig., 698 A.2d 959, 970 (Del. Ch. 1996) (noting "it is important . . . that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its [oversight] responsibility"). In the case In re Abbott Laboratories, 325 F.3d 795 (7th cir. 2003), the court found, among other things, that once the directors knew of a material problem, they took no action to initiate a process to make a decision as a board regarding how to address it; therefore, the business judgment rule presumption could not apply. The board of directors faced liability for inaction and director disengagement from proper oversight. *Id.*; *see also*, In re The Walt Disney Company, 906 A.2d 27, 33 (Del. 2006) (endorsing the following definition of lack of good faith, without limiting it, as "intentional dereliction of duty, a conscious disregard for one's responsibilities"); 17 C.F.R. §§229, 239, 240 and 274 (2010) (requiring enhanced disclosure for public companies regarding executive compensation, directors and nominees, board leadership structure and the board's role in risk oversight, compensation consultants and voting results).

[6] To the extent that the IR process traditionally has been viewed as a management-driven exercise while corporate governance traditionally has been viewed as a board/director-driven exercise, we note that there may be a general need to have the board more accessible for corporate governance discussions. The broader issue, however, is ensuring that the mechanics of the IR dialogue approach and the necessary intimacy required to facilitate dialogue between companies and parties interested in corporate finance that the IR function accomplishes is replicated in the context of corporate governance.

ongoing financial performance dialogue ensure that shareholders and the companies they own are consistently and effectively engaged on the issue of the financial and operational health of the company. To install this new dialogue model, however, shareholders, whether through reform or other action, should be involved and accountable for their voting decisions on governance related matters, and companies should become engaged in the information and assessment process regarding their own corporate governance practice. Further, the dialogue process only will be maximized if the process includes both the financial and governance decision-makers from the institutional investors.

II. To Facilitate Meaningful Corporate Governance Discussions, Proxy Advisory Firms Should Operate as an Objective Information Resource with No Appearance of Conflicts of Interest

There can be no meaningful debate over the rise in influence of the proxy advisory firms – not just on the annual proxy process, but also on the broader corporate governance debate. Many institutional shareholders rely heavily on proxy advisory firms to evaluate the governance policies of the companies they own, to develop policies to guide the exercise of proxies, and to vote those proxies during the annual proxy season.[7] And, because of their growing influence, questions have arisen about the firms' practices, conflicts of interests, and the efficacy of their ratings and recommendations.[8]

Proxy advisory firms can play a valuable role in ongoing company-shareholder discussions focused on corporate governance, and can in fact facilitate a more refined, timely and ongoing dialogue between companies and their owners. Proxy advisory firms are well situated to gather and provide companies and shareholders with governance evaluation information, provided that the information is complete and accurate, and the methodology for gathering,

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[7] Currently, RiskMetrics, the largest and most significant of the proxy advisory firms represents: 70 of the 100 largest investment managers; 42 of the 50 largest hedge funds; 16 of the 30 OECD central banks; and, most notably, 43 of the 50 largest mutual fund companies. RiskMetrics Group, Inc., Annual Report (Form 10-K), at 2 (Feb. 24, 2010); http://www.riskmetrics.com.

[8] A recent study by Charles W. Calomiris and Joseph R. Mason examines this phenomenon. The study found that "institutional investors enjoy private benefits from low-quality (noisy) ratings . . . all of which accrue to institutional investors at the expense of their clients, the ultimate investors." Charles W. Calomiris & Joseph R. Mason, "*Conflicts of Interest, Low-Quality Ratings, and Meaningful Reform of Credit and Corporate Governance Ratings,*" e21: Econ. Policies for the 21st Century, 4, April 19, 2010. Calamoris and Mason go on to note that "empirical research indicates that corporate governance rating firms' models are noisy and may be useless." *Id.* at 9. Indeed, commentators have completed studies and similar research showing that the corporate governance ratings as currently conceived, have little, if any, correlation to shareholder value. *See, e.g.*, Robert M. Daines, et. al., "*Rating the Ratings: How Good Are Commercial Governance Ratings?*" J. Fin. Econ., June 26, 2008 (also *available at*: http://ssrn.com/abstract=1152093) (concluding that governance ratings had limited or no success in predicting future stock performance or bad corporate outcomes and that the level of predictive validity for the governance ratings fell well below the claims made by the applicable rating agencies).

assessing and presenting the information is transparent. For the proxy advisory firms to play this critical role, and play it well, there are several areas where reform should be undertaken:

- Proxy advisory firms should be prohibited from providing voting recommendations to investors (or their advisors) concerning companies while they also provide governance consulting services and class action damages recovery services resulting in the appearance of conflicts of interest; and

- Proxy advisory firms should heed past criticisms for: (i) employing opaque methodologies; (ii) utilizing outdated, incomplete and inaccurate information; and (iii) not engaging in meaningful dialogue with companies to allow for the verification of facts, explanation of practices and to ensure that shareholders are informed when companies disagree with proxy advisory firms' recommendations.

Conflicts of Interest. Today, a single proxy advisory firm may offer governance consulting services, governance rating services, proxy voting services and securities class action consulting and claim valuation services. Given the important intermediary role that the proxy advisory firms play between companies and shareholders, it is inappropriate to employ a business model which has, under one roof, governance evaluation decision-making *and* the presence of ancillary services that potentially may profit from claims of poor governance. This model will invariably lead to conflicts.[9] To address these potential conflicts of interest, we suggest that the SEC explore requiring proxy advisory firms to completely separate their conflicting services into separate and distinct businesses – similar to the consulting services that accounting firms were required to separate by the Sarbanes-Oxley Act.

Methodology. Due to the cost constraints of evaluating each company independently, the proxy advisory firms tend to employ a one-size-fits-all governance ratings and advisory model that often fails to account for the multitude of factors across companies and industries that may be important in determining "good" corporate governance as it relates to a particular company. This approach too often lacks accurate facts about the company or an accurate understanding of a company's culture, and suggests governance conclusions without transparency as to the methodology and assumptions underlying such conclusions. The analogy would be having an analyst generate metrics in the IR process and make a recommendation to buy or sell without the benefit of any dialogue with the company to understand the circumstances

[9] Proxy advisory firms claim to contain these conflicts through the establishment of internal "firewalls" that separate those employees who work on proxy voting or governance ratings delivered to investors and those who provide proxy or governance consulting services to companies. The concept of a firewall is valid in any number of settings, but in the context of advising on corporate governance, firewalls are inadequate. Even the appearance of potential conflicts will chill a company's willingness to engage in open discussion about governance issues and, therefore, can compromise the ability of the proxy advisory firms to act as an effective intermediary between companies and shareholders.

underlying the financial metrics. This situation too often is happening with governance evaluations today.[10] For example, a company with staggered director terms or multiple classes of shares may have compelling reasons for such an approach, but the present "check the box" proxy advisory model would grade the company poorly. In addition, such "check the box" models too often fail to account for meaningful differences presented by the laws of the state of incorporation.

Further, under current practices, many institutional shareholders engage third-party proxy advisory firms to provide services beyond information gathering and reporting.[11] These services, like voting recommendations on corporate governance matters, are accompanied with little, if any, transparency about the level of delegation to the proxy advisory firms or the level of direct interaction between the company and the institutional investor over these issues.[12] When proxy advisory firms are used by shareholders as a resource, their role should be just that – a resource – not an intermediary between the shareholder and the company, whether in the context of proxy votes or in articulating shareholder positions regarding governance practices generally.

To improve the services provided to shareholders by proxy advisory firms, there should be direct, timely and open communication among the proxy advisory firms, companies and shareholders, to wit:

- In connection with a governance rating/report, the proxy advisory firms should be required to share in a timely manner with the covered company an advance report so that the company can react, correct errors and provide additional information and perspective.

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[10] Indeed, commentators have completed studies and similar research showing that the corporate governance ratings, as currently conceived, have little, if any, correlation to shareholder value. *See, e.g.*, Robert M. Daines, et. al., "*Rating the Ratings: How Good Are Commercial Governance Ratings?*" J. Fin. Econ., June 26, 2008 (also *available at*: http://ssrn.com/abstract=1152093).

[11] As noted in the Concept Release, proxy advisory firms often provide investors with two general types of services: governance ratings and proxy voting recommendations. Governance rating are generally some measurement of the effectiveness of a company's corporate governance as measured by the proxy advisory firm. They are typically numerical scores, compiled by staff under a "one size fits all" business model, which facilitates volume at the expense of customization or nuance. These governance ratings are then sold to investors for use in making investment, proxy voting and other decisions. The purpose of these governance ratings is to transform principles of "good" governance into a quantitative set of data that can be used to make voting decisions on governance matters with respect to a company. Proxy advisory firms go one step further in that they are also engaged by shareholders to provide voting recommendations on corporate governance issues. As with the governance rating, these voting recommendations are usually derived from a one-size-fits-all model that is not vetted, discussed or reviewed with companies.

[12] While proxy advisory firms can play a valuable role in the corporate governance review and evaluation process, to the extent that wholesale delegation to them is occurring, that practice should cease.

In addition, the company should be allowed to include a clarifying or opposing statement to the report.

- In connection with proxy advisory services, proxy advisory firms should likewise be required to give timely, advance notice to a company when it has a concern over a corporate governance policy that is likely to lead the firm to recommend to its shareholder customer that it oppose the company position.

These modest requirements would ensure not only that any given governance rating or proxy recommendation is based not on a static, one-size-fits-all formula, but rather on facts and company-specific analytics accounting for the unique circumstances and goals of a particular company, but also that companies have the opportunity to correct or disagree with findings and conclusions. The benefit of these reforms would be enhanced dialogue where companies and the shareholders could more confidently rely on the intermediary role the proxy advisory firms play.

III. The Relationship between Proxy Advisory Firms and Institutional Investors Should be Modified to Ensure Institutional Investors are Required to Engage Companies Directly on Corporate Governance Issues

With respect to U.S. publicly traded companies, the majority of shares are held by certain registered shareholders (often institutional investors) who hold these shares on behalf of the actual economic owners of the shares, the beneficial owners. Because a registered shareholder typically is an agent of the beneficial shareholder, registered shareholders generally are required to act in the best interests of their constituents. However, rather than bringing governance discussions into the IR process to facilitate direct dialogue, many shareholders, particularly institutional shareholders, have (1) delegated responsibility on corporate governance matters to in-house corporate governance divisions, (2) outsourced these responsibilities to proxy advisory firms who make governance decisions outside the established IR shareholder dialogue process, or (3) operate under a business model and investment objectives where their investment approach limits the ability to make investment decisions based on corporate governance outcomes (e.g., index funds, ETFs or "quant" firms).[13] Pension funds, mutual funds and other institutional investors, have shifted responsibility for corporate governance issues to these other parties for a variety of reasons. For example, the business model of institutional investors often emphasizes cost containment because these institutional investors are evaluated (and compensated) based on the quantitative financial returns they provide their clients. As a result,

[13] Certain classes of investors, such as index funds, ETFs and certain "quant" investors, may lack the traditional characteristics of a "shareholder" (i.e., one with an economic interest based on shares held (not borrowed) for a reasonable period) that would facilitate a governance discussion. For purposes of establishing shareholder dialogue, however, we note the prominence of these classes of investors in the practices of lending shares and empty voting. While addressing empty voting and share lending in detail is outside the scope of these comments, we would note that, as a general principle, these two mechanisms often serve to advance activists causes at the expense of meaningful shareholder dialogue on corporate governance.

corporate governance evaluation becomes less critical absent a direct, perceivable impact on share value, such as a proxy fight or egregious malfeasance by management. In short, many portfolio managers and their analysts do not see governance as material to their work and therefore do not inject governance discussions into the IR process.

Direct company-shareholder communication through the utilization of an approach similar to the IR function, if not the IR function itself, and periodic reporting/release requirements would give dignity to governance on parity with financial performance. Companies, shareholders, and the proxy advisory firms are all complicit in the lack of meaningful dialogue on governance topics. Companies often are willing to come to the table and discuss governance matters with shareholders, but are limited by, among other things, the often inadequate intermediary role that proxy advisory firms play in conveying corporate governance information to shareholders. At the same time, shareholders have complained that companies need to address supposedly "bad" corporate governance practices, yet these shareholders simultaneously outsource decision-making on corporate governance to third parties, including proxy advisory firms. To effectuate this new model, companies must be responsible for ensuring communication with shareholders; shareholders, particularly institutions to whom retail investors have entrusted their shares, must be responsible for making informed decisions on governance topics after evaluating all of the relevant facts and circumstances through informed discussions with companies; and the proxy advisory firms must reform their practices to ensure the presentation of accurate, unbiased information about companies to shareholders without the appearance of conflicts.

As noted above, in the U.S. securities market, the majority of shares are held by certain registered shareholders who hold these shares on behalf of the actual economic owners of the shares, the beneficial owners, who often are retail investors. Because a registered shareholder often is an agent of the beneficial shareholder, registered shareholders typically are required to act in the best interests of their constituents. Under current practices, however, many institutional shareholders engage third party proxy advisory firms to provide voting recommendations on corporate governance matters, with little, if any, transparency about the role that the proxy advisory firms play in determining those voting recommendations (e.g., impact on recommendations of an independently developed shareholder voting policy, if any) or the level of interface between the company and the institutional investor and, more importantly, the institutional investor and the ultimate shareholder.[14]

While proxy advisory firms can play a valuable role in the IR process, wholesale delegation to them should cease, and shareholders, especially institutional shareholders, should be held accountable for the votes they submit on governance matters. To hold shareholders accountable for their actions and to establish the appropriate role of proxy advisory firms, the

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[14] Increased transparency in the institutional investor approach to proxy voting also would assist in solving the share lending issues (and related impediments to meaningful shareholder dialogue) created when institutional investors lend shares out to other investors rather than vote the shares themselves.

SEC should consider whether proxy advisory firms should be required to make disclosures regarding voting policies and recommendations at the institutional investor level. In addition, when proxy advisory firms are used by shareholders as a resource, their role should be just that – a resource – not an intermediary between the shareholder and the company, whether in the context of proxy votes or in articulating shareholder positions regarding governance practices generally. While the proxy advisory firms can play a critical role in facilitating shareholder dialogue on corporate governance, the ultimate governance evaluation decision should be the responsibility of the shareholder rather than the proxy advisory firm.

IV. Conclusion

We encourage the SEC to seize the opportunity to improve corporate governance dialogue by encouraging companies to include governance as part of the investor relations process and to move away from isolating corporate governance to the proxy process. This approach facilitates a discussion between shareholders and companies based on validated facts and company-specific analytics, in a manner that can account for the unique circumstances and goals of a particular company. The proxy advisory firms are a critical resource in facilitating direct dialogue on corporate governance between companies and shareholders, but their approach to facilitating that dialogue must change to eliminate conflicts of interest and to improve the current volume-driven, one-size-fits-all approach.

Because this approach would "enhance the accuracy and integrity of the shareholder vote," we respectfully request the SEC to consider these comments during their review and reform of the U.S. proxy system.

Respectfully submitted,

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