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**Via Electronic Filing**

Elizabeth M. Murphy
Secretary
U.S. 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 Secretary Murphy:

The Cornell Securities Law Clinic ("the Clinic") welcomes the opportunity to comment on the Securities and Exchange Commission's ("Commission") Concept Release on the U.S. Proxy System, File Number S7-14-10 ("the Concept Release"). The Clinic is a Cornell Law School curricular offering in which law students provide representation to public investors and public education as to investment fraud in the largely rural "Southern Tier" region of upstate New York. For more information, please see http://securities.lawschool.cornell.edu.

The Concept Release proposes several regulatory schemes for minimizing conflicts of interest by proxy firms. The Clinic addresses two of the proposed approaches: 1) requiring specific disclosures regarding the presence of potential conflicts of interest under Exchange Act Rule 14a-2(b)(3) and 2) providing additional guidance on the fiduciary duty of proxy advisors registered as investment advisers so that they may deal fairly with clients by disclosing any material conflicts of interest.

**Background**

Institutional investors, who cast the majority of proxy votes and who typically manage large numbers of stock holdings, often seek the assistance of proxy advisory firms ("proxy firms") to determine how to vote on management and shareholder proposals, thereby fulfilling their fiduciary duty to their clients. Institutional investors include investment advisers, pension plans, employee benefit plans, bank trust departments, and funds.[1]

Proxy firms are primarily known for providing research and voting recommendations to institutional investors and counseling issuers on corporate governance best practices. Five major

[1] Concept Release on the U.S. Proxy System; Proposed Rule, 75 Fed. Reg. 42982, 43009 (July 22, 2010).

proxy firms are in operation today. They include Institutional Shareholder Services (ISS), Macro Consulting Group (MCG), Glass Lewis & Company (Glass Lewis), Proxy Governance (PGI), and Egan-Jones Proxy (Egan-Jones).[2] Together, these proxy firms provide services to approximately 2,850 clients (with ISS alone servicing approximately 1,700) whose assets total over $41 trillion dollars.[3]

Proxy firms have an influential role and function in the financial markets. As the concept release points out, proxy firms provide a multitude of services to both institutional investors and issuers, both of whom are consumers of advisory services. For example, institutional investors hire proxy firms to provide services such as analysis and formulation of voting recommendations presented for shareholder vote; the execution of those votes; assistance with administrative tasks associated with voting; and mitigating conflicts of interest when institutional investors cast votes in a way that conflicts with the interests of their clients. Issuers, on the other hand, hire proxy firms to provide consulting services on corporate governance and executive compensation matters, which may include the assistance of developing proposals to be submitted for shareholder approval.

An inherent conflict of interest arises when a proxy firm provides advisory services to an issuer and then advises an institutional investor to vote for the issuer's recommendations – recommendations that the proxy firm potentially created.[4] Consequently, common criticisms of proxy firms are that 1) proxy firms make favorable recommendations to institutional investors regarding an issuer's shareholder proposal in order to maintain the issuer's business in the future and 2) issuers hire proxy firms for the sole reason of receiving the proxy firm's support for the issuer when voting recommendations are made.[5]

## 1. The Commission Should Provide Guidance or Revise Rule 14a-2(b)(3), Thereby Requiring Conflict of Interest Disclosures by All Proxy Firms

The Commission asks whether additional regulation of proxy advisory firms is necessary or appropriate for the protection of investors.[6] Requiring all proxy firms to provide specific disclosures regarding potential conflicts of interest would help institutional investors verify the integrity and independence of those recommendations, ensuring a robust voting process. Therefore, the Clinic supports increased disclosure by all proxy firms about potential conflicts of interest.

Exchange Act Rule 14a-2(b)(3) requires that a person furnishing proxy voting advice to another must disclose to its client "any significant relationship" or "material interests" it has with

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[2] GAO Report to Congress, Corporate Shareholder Meetings – Issues Relating to Firms That Advise Institutional Investors on Proxy Voting (June 2007) ("GAO Report") at 7.
[3] *Id.* at 13.
[4] Concept Release on the U.S. Proxy System; Proposed Rule, 75 Fed. Reg. 42982, 43012 (July 22, 2010).
[5] *Id.*
[6] *Id.* at 43013.

the issuer.[7] Although some proxy firms currently provide generic disclosures to institutional investors stating that they "may" have a consulting relationship with the issuer, such disclosures are vague and ineffectual. These notices insufficiently inform the reader that conflicts of interest destroy the recommendation's independence – information that institutional investors may wish to consider before accepting the proxy firm's recommendations. Thus, the Commission should require all proxy firms to disclose, in detail, potential conflicts of interest.

Institutional investors should have the ability to evaluate conflicts of interest where a proxy firm provides advisory services to the institutional investor about an issuer that is also receiving, or has received, advisory services from the same proxy firm. To facilitate the institutional investor's understanding, the Commission should require proxy firms to disseminate a disclosure form explaining potential conflicts of interest in clear language. The disclosure should explain that because the issuer provides (or has provided) the proxy firm economic benefit, this creates a conflict of interest that gives the proxy firm an incentive to favor the issuer's proposal. It should also disclose whether the proxy firm has an interest in receiving future business from the issuer. Proxy firms should also describe how they address conflicts that do exist, including procedures for disclosing such conflicts to institutional investors. And if a conflict arises during the provision of services or the proxy firm decides to engage in a practice that it had not previously disclosed to the institutional investor, supplementary disclosure should be required. These disclosures will help institutional investors assess and verify whether the proxy firm's recommendations are in their best interests.

Requiring proxy firms to provide specific disclosures would put institutional investors on notice, encouraging institutional investors to review the recommendations more carefully. Indeed, research suggests that some institutional investors do not scrutinize proxy firm recommendations.[8] Principally, disclosure will guard against misrepresentation by a proxy firm and make it more likely that institutional investors are accurately informed. The concept proposal appears to be aimed at providing institutional investors greater information and disincentivizing proxy firms from engaging in activities that are contradictory to the interests of the proxy firm's clients.[9] It allows institutional investors to make decisions more deliberately and increases transparency. For these reasons, the Commission should provide additional guidance regarding the requirements of Rule 14a-2(b)(3) or revise the rule so that it requires all proxy firms to disclose conflicts of interest.

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[7] 17 CFR 240.14a-2(b)(3).

[8] Stephan Choi, Jill Fisch & Marcel Kahan, *The Power of Proxy Advisors: Myth or Reality?*, 59 EMORY L.J. 869, 872 (2010).

[9] *See generally*, comment letter to Proxy Disclosure and Solicitation Enhancements, Release No. 33-9052 (July 10, 2009) [74 FR 35076] from Oppenheimer Funds, at 2 (arguing that absent full disclosure, proxy firms have the same potential for abuse that occurred a number of years ago when investment banks raising capital for issuers also provided investors with buy and sell recommendations with respect to the same issuers, or like public accounting firms that provided opinions on the financial health of issuers while also providing a host of other consulting services to the same issuers, a practice no longer permitted).

**2. The Commission Should Provide Guidance on the Fiduciary Duty of Proxy Firms Registered as Investment Advisers and Require Disclosure of Conflicts of Interest**

The Commission asks whether it should provide additional guidance on the fiduciary duties of proxy firms that are investment advisers[10] to deal fairly with current and potential clients by disclosing material conflicts of interest.[11] The Commission should provide additional guidance because doing so will engender transparency and equip institutional investors with information that can potentially inform how voting recommendations were determined.

Commentators have remarked that because proxy firms do not have a financial stake in the companies about which they provide voting advice, they owe no fiduciary duties to the shareholders of these companies, nor are they subject to any meaningful regulation.[12] Investment adviser, however, are subject to a standard of fiduciary care under the Investment Advisers Act of 1940.[13] Thus, proxy firms registered as investment advisers owe a level of fiduciary care to their clients. The Supreme Court noted in *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 196 (1963), that an investor (such as an institutional investor) seeking the advice of a registered investment adviser (such as a proxy firm registered as an investment adviser) must be permitted to evaluate overlapping motivations through appropriate disclosures to assist it in deciding whether the adviser has conflicting economic motivations. The Court therefore held that the Investment Advisers Act of 1940 requires an adviser to make full and frank disclosures of his practice of trading on the effect of his recommendations. *Id.* at 197.

The Commission requires investment advisers to disclose to clients material conflicts of interest on Form ADV 2A.[14] The Commission clearly states on Form ADV 2A that the investment adviser, as a fiduciary, must seek to avoid conflicts of interest with their clients, and, at a minimum, make full disclosure of all material conflicts of interest between the adviser and the client that could affect the advisory relationship.[15] The Commission then asks a number of questions and requires the adviser to disclose conflicts of interest in circumstances where, for example, the adviser accepts compensation for the sale of securities, engages in third-party business relationships, etc. There is no rule, however, requiring a conflict of interest disclosure by proxy firms that are registered as investment advisers. The Commission should require such disclosures because proxy firms face conflicts of interest where it provides advice to both institutional investors and issuers regarding the same concern.

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[10] As the GAO report notes on pages 8 and 9, three out of the five major proxy advisory firms (ISS, MCG, and PGI) are registered as investment advisers with the SEC. These firms have self-identified as pension consultants as the basis for permitting them to register as investment advisers under Rule 203A-2(b) of the Investment Advisers Act.

[11] Concept Release on the U.S. Proxy System; Proposed Rule, 75 Fed. Reg. 42982, 43013 (July 22, 2010).

[12] Choi, Fisch & Kahan, *supra* note 4, at 872.

[13] *See generally* Proxy Voting by Investment Advisers. Final Rule: Proxy Voting by Investment Advisors, Investment Advisors Act Release No. 2106 (Jan 31, 2003).

[14] *See* http://www.sec.gov/about/forms/formadv-part2.pdf , pg 1.

[15] *Id.* at 1.

As previously discussed, disclosure provides institutional investors information about how the recommendations were determined and disincentivizes proxy firms from engaging in activities that are contradictory to the interests of the investment adviser's clients. For these reasons, the Commission should provide additional guidance on the fiduciary duties of proxy firms that are investment advisers to disclose material conflicts of interest by, for example, requiring disclosure on Form ADV 2A.

**Conclusion**

The Clinic appreciates the opportunity to provide our comments to the Commission. Proxy firms currently have limited accountability yet they provide important and influential advisory services to institutional investors and issuers. Because of the potential conflicts of interest that are present in providing advisory services to both issuers and institutional investors, the Clinic supports the Commission in 1) providing interpretative guidance on or revising Exchange Act Rule 14a-2(b)(3) to require disclosures by all proxy firms regarding conflicts of interest and 2) providing additional guidance on the fiduciary duty of proxy firms registered as investment advisors to disclose conflicts of interest. Requiring conflicts of interest to be disclosed will assist institutional investors in determining whether the voting recommendations by proxy firms are truly independent.

Respectfully Submitted,

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