October 20, 2010

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

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

Dear Ms. Murphy:

I am pleased to submit comments to the U.S. Securities and Exchange Commission (the "Commission") in response to the Commission's release entitled "Concept Release on the U.S. Proxy System" (Release Nos. 34-62495; IA-3052; IC-29340) (File No. S7-14-10) ("Concept Release")[1] on behalf of the independent directors of 43 open-end and closed-end funds. In the past several years, we have dealt with proxy advisory firms on a variety of issues common to the open-end and closed-end fund business, including issues surrounding contested elections and proposals from both professional dissidents and ordinary investors, what, if anything, to do about the frozen market for auction-rate preferred shares ("ARPS"), new advisory agreement proposals and whether a fund's investment adviser and sub-adviser, in voting portfolio securities, could rely on their proxy advisory firm to be knowledgeable about the issues and free from conflicts of interest.

Proxy advisory firms play an important role in the proxy voting process. We believe, however, that improvements could be made in regard to their role in the process that would benefit the proxy system as a whole.[2]

I. Criteria and Processes that Proxy Advisory Firms Use to Formulate their Recommendations

We have several concerns with respect to the criteria and processes that proxy advisory firms use to formulate their vote recommendations. First, we understand that at least one prominent proxy advisory firm has a policy of not discussing proxy proposals with issuers, shareholder proponents or other interested parties individually and has refused to meet with representatives of closed-end funds to discuss the funds' proposals prior to finalizing its vote recommendations on those proposals. While this policy may be intended to avoid undue

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[1] *Concept Release on the U.S. Proxy System*, Investment Company Act Release No. 29340 (Jul. 14, 2010) [75 FR 42982 (Jul. 22, 2010)] (the "Concept Release").

[2] We note that the Investment Company Institute intends to submit a comment letter on the Concept Release that addresses how mutual funds use proxy advisory firm services, such as voting recommendations. Our letter, in contrast, focuses largely on the effect that the current proxy voting process has on funds and/or their board members when they are the subjects of, rather than the users of, proxy advisory firm voting recommendations.

influence, it can lead, and in our opinion has in fact in some cases led, to an incomplete understanding and analysis of the facts.

Issuers can often provide proxy advisory firms with information about the context of the proxy proposals under consideration. The public record is typically comprised of numerous public filings and other information,[3] and a proxy advisory firm may not have the time or resources to integrate this array of information to the degree necessary to obtain a clear understanding of the issuer and the issues it faces. Furthermore, one side or the other in a proxy contest may take advantage of its relationship with the press to "paint" the public record with stories flattering to its point of view. Our concerns on this score are heightened because we understand that many analysts hired by proxy advisory firms are seasonal employees.[4] We believe they would benefit greatly from assistance in integrating the wide variety of information available about most public companies.[5]

In addition, when considering the election of directors, we think proxy advisory firms could benefit from discussing a candidate's qualifications and prior experience with the candidate directly. Although the public record may be materially complete in a legal sense, it rarely conveys a full picture of board members' evaluation of the issues at hand, their diligence or their commitment to investors. The candidate may be able to provide additional context on his or her background and could answer questions the proxy advisory firms may have.

Second, we are concerned with the practice of at least one proxy advisory firm to implement what is effectively a "one-size-fits-all" policy that applies one vote recommendation to all similar proxy proposals without analyzing the issue on a company-by-company basis. In some situations, the use of a one-size-fits-all policy leads to an incomplete analysis that does not take into consideration specific facts and circumstances that may affect one issuer and not another. Voting rights are meant to provide parties who have an economic interest in a corporation (*i.e.*, shareholders) a measure of influence over how the corporation is governed. Voting recommendations based on analyses that do not take into account an issuer's specific circumstances seem more akin to general policy pronouncements than to a determination of what is best for a particular issuer and its shareholders.

Recent proxy solicitations for the election of closed-end fund directors who are elected by the holders of ARPS highlight the impact of these two concerns. At least one proxy advisory firm appears to have instituted a policy that places predominant weight on the percentage of ARPS redeemed by a fund. We understand that the firm has consistently recommended that preferred shareholders do not submit votes or withhold votes from any incumbent preferred-

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[3] For example, proxy statements, shareholder reports, registration statements and press releases.

[4] *See e.g.*, Eleanor Laise, *Is This The Most Influential Man on Wall Street?*, SMARTMONEY, Oct. 1, 2002.

[5] Note that we are not suggesting that proxy advisory firms seek to gain access to non-public information through meetings with issuers, but rather that they could gain a better understanding of how to integrate and interpret all the information that is already in the public record.

share director[6] seeking re-election to the board of a closed-end fund that has not redeemed at least a specified percentage of ARPS (the "Voting Policy"). The Voting Policy is effectively a bright line test that applies to every closed-end fund that has issued ARPS. To our knowledge, the proxy advisory firm did not announce or otherwise inform the closed-end fund industry, or its clients, that it was considering implementing the Voting Policy and did not give closed-end funds an opportunity to comment on or meet with the firm before it implemented the policy. Closed-end funds learned of the policy only as the proxy advisory firm began to apply it to proxy solicitations, including solicitations for uncontested elections. Moreover, closed-end funds that have met with this proxy advisory firm since its adoption of the Voting Policy have been told that the firm will not vary from this policy at least for this year, regardless of the merits or even relevance of this Voting Policy as applied to the specifics of a particular issuer, nominee or election.

By implementing this apparent one-size-fits-all policy and refusing to consider factors that may distinguish one issuer's situation from another, the proxy advisory firm's analysis ignores other considerations that we believe are essential to an effective analysis. For example, because the Voting Policy makes the election of a director effectively a vote solely on the board's actions on ARPS redemptions, it ignores the qualifications and experience of the director nominee. It also disregards the possibility that the nominee may actually be in favor of ARPS redemptions even though a majority of the board disagrees. The Voting Policy also does not appear to take into account the specific facts and circumstances that the board may have considered when it determined not to redeem ARPS at the level specified by the proxy advisory firm.

Because every fund's situation is different, it is possible that a redemption of ARPS of a particular magnitude or at a particular time may not be in the best interest of a specific fund or that fund's preferred shareholders. For example, the boards of many closed-end funds that did redeem ARPS are now facing litigation by common shareholders claiming that the fund should not have paid full price (*i.e.*, full liquidation preference) for the preferred shares.[7] While we believe these cases, if litigated, ultimately will prove to have no merit, funds that redeem ARPS in today's environment may choose to offer the holders a price below the full liquidation preference out of concern about a potential lawsuit by common shareholders, whereas if fund boards wait until some of the current cases are resolved, they may have more room to consider offering preferred shareholders the full price. In addition, the alternative leverage options available to a fund may disadvantage remaining preferred shareholders if they dilute the voting power of the remaining ARPS holders.[8]

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[6] As you know, Section 18(a)(2) of the Investment Company Act of 1940 ("1940 Act") requires a closed-end fund that has preferred shares outstanding to have two board members elected by the vote of only the preferred shareholders.

[7] *See e.g.*, Peter Ortiz, *Common Shareholders Target New Firms With ARPS Lawsuits*, IGNITES, Sept. 2, 2010.

[8] For example, a fund may issue term preferred shares, such as MuniFund Term Preferred shares ("MTPs"), and use the proceeds to redeem one half of its ARPS. Because the MTPs are traded

The proxy advisory firm that applies an apparent one-size-fits-all policy to this situation also fails to consider that opposition candidates for preferred-share director positions may be sponsored by professional dissidents who have other agendas not related to the redemption of ARPS. Those aims may not be in the best long-term interests of the fund and its preferred or common shareholders. By recommending that its clients do not submit votes or withhold votes from the incumbents based primarily on a single issue, a firm may help these dissidents elect their candidates even though the analysts do not understand those candidates' full agenda for the funds.

Furthermore, the Voting Policy could lead to widespread withholding of votes, even in uncontested elections. This will prevent many funds from achieving a quorum with respect to the election of the preferred-share directors. If the incumbent is not allowed to remain in office until a successor is elected, the issuer would have to find another way to comply with the requirement under the 1940 Act that two directors be elected by preferred shareholders.[9]

II. Conflicts of Interest

As noted in the Concept Release, issuers may hire proxy advisory firms to provide consulting services or rate the issuers' corporate governance policies.[10] This means that some proxy advisory firms have been in the situation of analyzing proxy proposals issued by a paying client, or even proposals that they helped to prepare. In addition, other clients of the proxy advisory firms, such as broker-dealer firms, may have a substantial financial interest in the outcome of a specific shareholder vote. We are concerned that these conflicts of interest could unduly influence the proxy advisory firms' voting recommendations.

Some proxy advisory firms have established internal "fire walls" or other methods to mitigate the potential influence of conflicts of interest.[11] Without disclosure or other regulation,

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on an exchange, they have a significantly lower liquidation preference (and therefore market price) per preferred share than ARPS. Under the typical one-share, one-vote policy, the holders of the MTPs, in the aggregate, would then have significantly more voting power than the holders of the remaining ARPS, even though both groups would have invested the same amount of money overall.

[9] We also share the more general concern expressed by some commentators and researchers that there is not necessarily a correlation between proxy advisory firms' voting recommendations and good corporate governance. Some studies have been conducted in an effort to determine whether specific corporate governance policies (*e.g.*, board composition or adopting a poison pill) correlate with benefits to shareholders. However these studies either have not found a strict correlation or have come under criticism for not taking into account all factors that could have an effect on firm performance. Paul Rose, *The Corporate Governance Industry*, 32 J. Corp. L. 887, 910-912 (2007).

[10] *See* Concept Release at 43009.

[11] *Id*.

however, investors who rely on the proxy advisory firms cannot be confident that adequate measures are being taken to mitigate these conflicts. In addition, although "fire walls" could address specific conflicts of interest, such as a conflict arising from an issuer paying a proxy advisory firm to consult on corporate governance, they do not address more structural conflicts of interest. For example, we believe proxy advisory firms had a conflict of interest when creating the Voting Policy discussed above because it was well known that many broker-dealers, who are some of the firms' significant clients, had an economic interest in having as many ARPS redeemed as possible.[12] "Fire walls" would not have been able to address this conflict of interest because the interest of this major group of clients was too widely known to be screened off by such a device.

III. Power and Influence

Over the past several years, actions of the Commission and Commission staff have increased the power and influence of the proxy advisory firms. For example, in a January 6, 2009 no-action letter,[13] Commission staff granted no-action relief to broker-dealers who had purchased ARPS from their past or current customers. In the letter, Commission staff stated it would not recommend enforcement action if the Affiliate Restrictions[14] were violated solely because of the broker-dealers' holdings of ARPS. A condition of this relief was that if a broker-dealer holds more than 25% of the outstanding shares of the class of preferred stock of a fund, the broker-dealer must vote its shares of such preferred stock as directed by an independent third party (such as the trustee of the voting trust or a proxy adviser).[15]

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[12] As a result of actions taken by broker-dealer firms to assist their clients or settle with regulators, many broker-dealers became owners of a large percentage of the ARPS of various closed-end funds over the past two years. This ownership gave these broker-dealers a financial interest in having as many ARPS redeemed as possible.

[13] Davis, Polk & Wardwell, SEC Staff No-Action Letter (Jan. 6, 2009) ("ARPS No-Action Letter").

[14] The term "Affiliate Restrictions" is defined in the no-action letter as the provisions of the 1940 Act and the rules thereunder applicable to a fund, an affiliated person (as defined in Section 2(a)(3) of the 1940 Act, including but not limited to paragraph (C) of Section 2(a)(3)) of a fund or an affiliated person of an affiliated person of a fund. (Section 2(a)(3)(C) declares that a person directly or indirectly controlling, controlled by or under common control with the another person is an affiliate of that person.) As you know, Section 17 of the 1940 Act prohibits such first- or second-tier affiliates from engaging in a variety of transactions with the fund.

[15] Unfortunately, under the ARPS No-Action Letter, broker-dealers were only required to vote with "an independent third party" when voting on preferred share matters. Because the Letter contains no requirement for a broker-dealer to follow the same independent third party each time it votes, the broker-dealers are essentially allowed to choose on a case-by-case basis which voting recommendation to follow on each proxy proposal. If different proxy advisory firms have different voting recommendations, the broker-dealers can vote however they want by following the proxy advisory firm's recommendation that is most agreeable to their interests.

As another example, Rule 206(4)-6 under the Advisers Act of 1940, as amended (the "Advisers Act"), requires investment advisers to adopt written proxy voting procedures that state, among other things, how the adviser addresses material conflicts that may arise between the adviser and its clients. In the Rule's adopting release, the Commission stated that one way an adviser could demonstrate that its votes were not the product of a conflict of interest, was to vote the client securities based upon the recommendations of an independent third party.[16] We understand that many advisers' proxy voting procedures follow this suggestion and vote proxies using the recommendations of proxy advisory firms, at least where the adviser itself has a conflict of interest.

Because so many institutional shareholders, such as broker-dealers and investment advisers, utilize voting recommendations from proxy advisory firms, the proxy advisory firms have a great deal of influence over the policies of public issuers.[17] For example, we believe that many incumbent preferred-share directors of closed-end funds were not re-elected this year, even in uncontested elections, because a substantial number of votes were withheld or the proxies were not returned based on at least one proxy advisory firm's recommendation (as discussed above).

The ARPS No-Action Letter and Rule 206(4)-6 under the Advisers Act encouraged the use of third party voting recommendations as a way to ensure that broker-dealers and advisers avoid conflicts of interest when exercising their discretionary voting authority. However, these actions by the Commission and its staff appear to have inadvertently contributed to a consolidation of voting power within a small group of entities that are subject to their own conflicts of interest and other limitations. In adopting these measures, the Commission may not have fully appreciated that the proxy advisory firms are businesses like any other, and may be subject to the same pressures and influences as any other business.

We expect that the new proxy access rules adopted by the Commission on August 25, 2010 would only increase the influence and power of proxy advisory firms.[18] These proxy access rules will, among other things, allow shareholders to place their nominees on the issuer's

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[16] *Proxy Voting by Investment Advisers*, Investment Advisers Act Release No. 2106 (Jan. 31, 2003) [68 FR 6585 (Feb. 7, 2003)] (the "Adopting Release").

[17] Rose, *supra* note 9, at 889-890 (discussing the level of influence that proxy advisory firms have on corporate governance through their control of shareholder votes).

[18] *See Facilitating Shareholder Director Nominations*, Investment Company Act Release No. 29384 (Aug. 25, 2010). The Commission has recently suspended the effectiveness of these rules pending the outcome of a lawsuit. *See In the Matter of the Motion of Business Roundtable and the Chamber of Commerce of the United States of America*, Securities Act Release No. 9149 (Oct. 4, 2010).

ballot. We anticipate that this will result in an increase in the number of election contests that proxy advisory firms will have to analyze.[19]

IV. Potential Regulatory Responses

As the Concept Release notes, the Commission has several legal avenues through which it might regulate proxy advisory firms. Whatever avenue the Commission chooses, we note that existing Commission rules are not very well suited to the proxy advisory firms' business. We believe the following are essential elements of any plan to regulate the services:

A. Disclosure of Methodology and Conflicts of Interest

We believe proxy advisory firms should be required to more fully disclose, at least to their clients, the methods and resources they use when formulating vote recommendations. In general, we think it would be helpful for proxy advisory firms to disclose how they formulate their broad voting guidelines that apply to all proxy proposals, as well as any "quality control" procedures in place to ensure that voting recommendations follow these guidelines.[20] With respect to specific voting recommendations, we believe disclosure should be made regarding: (1) the information the proxy advisory firm considered; (2) the nature of the proxy advisory firm's review and evaluation; (3) the educational background and experience of each analyst involved in preparing the recommendation, along with the number of hours spent on the matter by each (this would help clients understand the relative attention given to an issuer and a matter by senior reviewers and more junior analysts); (4) whether a case-by-case analysis or a one-size-fits-all policy was used to make the vote recommendation; (5) a description of any role the proxy advisory firm had in formulating the proxy proposal; and (6) the names of all outside parties who had contact with the proxy advisory firm about the proxy proposal.

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[19] We are also concerned about the ability of proxy advisory firms to provide a complete and accurate analysis of every proxy contest as the volume of contested elections increases and as relatively unseasoned individuals with less of a public record present themselves for election. There are relatively few proxy advisory firms in existence and we are concerned about whether they have the capacity to handle this increased load. As volume increases, it is even more important to ensure that processes are in place to handle conflicts of interest and that issuers are allowed to discuss the context of proxy proposals with the proxy advisory firms, to help them understand quickly the context of the proposal or election contest. It is also important that measures be in place to ensure that clients of proxy advisory firms are able to monitor the quality of the firms' analyses as these changes take place – through disclosure of the firms' methods if nothing else. Without such measures, and with an increase in volume of proxy proposals to evaluate, proxy advisory firm governance recommendations could become self-fulfilling and, consequently, best practices could become controlled by a small group of firms that have no responsibility for the outcome.

[20] We know of at least one proxy advisory firm that currently describes its annual process for updating its proxy voting guidelines. We believe this information is helpful for clients and issuers to understand how guidelines are established and how they can participate in the corporate governance dialogue. We believe all proxy advisory firms should make this type of disclosure.

In our opinion, this information will help institutional investors who rely on voting recommendations to understand what information was considered and what types of analysis were utilized to produce a recommendation. Similarly, requiring proxy advisory firms to provide information about potential sources of conflicts of interest and the background of their analysts can make the firms more accountable. Finally, providing this type of information should make the voting recommendation process more transparent in general, which will give the public and the Commission a better understanding on an ongoing basis of how proxy advisory firms operate and how they exercise their power.

B. Provide Issuers and Proxy Proposal Sponsors with Copies of Voting Recommendation Reports before they are Issued

We believe the issuer and any other proxy proposal sponsors should have the opportunity to review a preliminary draft of the proxy advisory firms' vote analysis and recommendation and to discuss the recommendation with the proxy advisory firms prior to the report being issued. In the first instance, this will help avoid obvious factual mistakes in the analysis. Proxy advisory firms make thousands of recommendations a year and it is inevitable that factual mistakes will occur. Providing a preliminary report to the issuer or other proposal sponsor would reduce the number of mistakes made. Secondly, as discussed above, we believe that proxy advisory firms will be able to perform a more complete analysis if they have the opportunity to discuss with the issuer or proposal sponsor the context in which the proposal is being made.

C. Require Proxy Advisory Firms to Take Measures to Ensure Vote Recommendations are Not Unduly Influenced by Conflicts of Interest

We recommend that the Commission require that proxy advisory firms take measures designed to ensure that voting recommendations are based on a thorough analysis of the facts and are not the product of a conflict of interest or an undisclosed bias. Like broker-dealers disclosing conflicts with respect to their research reports, for example, proxy advisory firm analysts could execute certifications relating to the views expressed in their voting recommendation reports and could confirm that no part of their compensation is tied a particular recommendation or view expressed in their reports. Fire walls are helpful in many circumstances, but we also believe that measures need to be taken to ensure that structural conflicts of interest, as discussed above, do not improperly influence vote recommendations. Thus, the proxy advisory firms should be subject to anti-fraud and fiduciary duty standards comparable to those under Section 206 of the Advisers Act.

D. Encourage Proxy Advisory Firms to Use Permanent Professional Staff

The Commission might also use its regulatory authority in ways that would encourage the development of a more permanent and professional group of analysts at the proxy advisory firms. We understand that a major reason the services use many seasonal employees is the bulge in corporate solicitations that occurs every year during the spring "proxy season." We believe that the proxy advisory firms simply do not find it economical to maintain a year-round staff large enough to accommodate this short-term bulge. Instead, we understand that they hire many temporary employees for the peak season or outsource the work.

The Commission should consider whether its regulatory authority might be used to smooth out this bulge in proxy solicitations, which we believe occurs largely for historical reasons. If the schedule of issuers' annual meetings were spread more evenly over the calendar year, proxy advisory firms could maintain a consistent level of staffing, which would encourage the development of a group of long-term professional employees with a better understanding of corporate matters in general as well as particular issuers.

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My fellow board members and I appreciate the opportunity to comment on the Concept Release and the efforts by the Commission and Commission staff to review the U.S. proxy system.

Sincerely,

/s/ Tom D. Seip