National Investor Relations Institute

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October 20, 2010

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

Re: Concept Release on U.S. Proxy System
File No. S7-14-10

Dear Ms. Murphy,

This letter is submitted on behalf of the members of the National Investor Relations Institute ("NIRI"). NIRI is the professional association of corporate officers and investor relations consultants responsible for communications among corporate management, shareholders, securities analysts and other financial community constituents. Founded in 1969, NIRI is the largest professional investor relations association in the world with more than 3,500 members representing 2,000 publicly held companies and approximately $5.4 trillion in stock market capitalization.

Introduction

NIRI supports and appreciates the SEC's effort to evaluate and improve the U.S. proxy system, the roots of which were established more than thirty years ago. NIRI believes that an effective, accurate and transparent proxy system that ensures equality among shareholders is a fundamental element of healthy capital markets. And efficient two-way shareholder/issuer communications are crucial to achieving these goals. Principles such as these are critical to ensuring confidence in U.S. capital markets.

NIRI is mindful that the mission of the SEC is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. In keeping with the principles embodied in this mission, NIRI believes issuers should have access to timely, accurate and transparent shareholder ownership information, ideally in the form of both long and short positions. NIRI believes that U.S. financial markets must be structured and regulated with investor protection as a top priority. Further, the integrity of our capital markets should not be disadvantaged, or weakened, by individuals with holding periods of extremely short duration, or special interest groups – or any combination thereof.

With these ideas in mind, NIRI is pleased to present the following perspective on the Commission's Concept Release on the U.S Proxy System ("concept release").

Proxy Advisory Firms

It is the opinion of many that the problems (or perceived problems) that exist with proxy advisory firms reflect a much larger problem; the separation of shareholder ownership, through the investment process, and corporate governance. Often, these functions are pursued independently from one another. The current investment process appears to incorporate corporate governance issues only during proxy season. This creates an opportunity for some stock market users to focus on governance during the annual proxy in a manner that allows for a quick profit at the expense of long term investors, including individual shareholders.

Individual shareholders may choose not to vote due to a lack of concern, or understanding, about the issues, and a belief that their vote does not matter. NIRI believes that individual investors are also disadvantaged by the influence of proxy advisory firms who provide private voting recommendations to groups of institutional holders that typically vote in accordance with these firms' recommendations. Individual shareholders are not privy to these recommendations or their reasoning.

For many institutional investors, the governance function *has* become isolated from the investing function, and may be perceived as a risk management function. Votes are cast based on governance preferences and advisory firm recommendations rather than a direct assessment of the potential impact of specific proposals on company valuations. For example, pursuing specific governance policy goals by casting votes against directors is not necessarily a good governance policy or an effective communications tool. In practice, proxy advisory firm recommendations against individual directors often bear no relation to the directors' culpability for the governance element which led to the "vote no" recommendation. These negative recommendations may ignore directors' valuable contributions to companies which, in some cases, include governance and/or executive compensation thought leadership. Institutions reliance on proxy advisory firms often seems driven by a need for compliance rather than an evaluation of the best company-specific vote. NIRI is not aware of any empirical evidence that supports any governance best practice standards that leads to superior or even improved financial performance. The one-size-fits-all paradigm employed by these firms seems unsupportable.

NIRI views the proxy advisory firm model as one embedded with conflicts of interest. The need for this service appears to be driven by a perception or risk of controversy. Threatened with a "vote no" recommendation, issuers feel obligated to engage the firm's consulting arm to obtain its analysis prior to finalizing the proposal and ensure a positive recommendation. Because the executive compensation plan decision models used by these firms for are a "black box" and lack transparency, issuers are reluctant to incur the effort and expense of launching a proposal without first paying for the proxy advisory firm's review. This exercise may add little shareholder value, but certainly adds to shareholder expense and creates a potential conflict of interest for the proxy advisory firm.

By their nature, proxy advisory firms are adversarial; without recommendations against management's proposals, the need for these services become unnecessary. The lack of direct pecuniary interest in the issuers and lack of accountability for results of voting recommendations creates the opportunity for bias against management. NIRI is concerned about the lack of

transparency of the existence of protocols against gift giving and receiving on the part of firm analysts and others by those seeking to influence the voting recommendation of these firms. In addition, some proxy advisory firms do not allow company input to their proxy research process even to correct inaccuracies. Finally, charging issuers to understand their quantitative models creates an inappropriate conflict of interest and imbalance of power for proxy advisors.

It was for these reasons that NIRI and the Society of Corporate Secretaries and Governance professionals collaborated on a "Discussion Draft" (attached) on proxy advisory services and provide specific recommendations for consideration.

To further support change in this area, NIRI offers the following two examples:

- In one company, MSCI (through its recent acquisition of RiskMetrics) recommended a vote against the chair of the board compensation committee due to tax gross-up on a new CEO compensation package. The recommendation by MSCI-RiskMetrics reflects its governance policy; it was not related to the company, Board or CEO performance.

- In another company, MSCI-RiskMetrics recommended a vote against three board compensation committee members due to granting "extra" pension service credit to a new CFO hired in 2009, declaring pensions should be "retention devices" rather than potential employee compensation bargaining tools. Even after explaining the flaw in their logic, (the additional years will not accrue until five years of employment have been obtained; i.e. it accomplishes the objective of retaining the executive), they recommended votes against.

NIRI supports the recommendations of the attached Discussion Draft and further recommends, or reinforces, the following recommendations:

<u>For Institutional Investors</u>

- Promote separation of governance policy preferences with voting responsibility.

- Promote other existing methods for communicating with Boards and company management regarding governance preferences rather than via proxy voting.

- Promote the concept that professional investors can rely on their overall assessment of the management of the company, which would allow votes consistent with management recommendations if they are generally happy with the direction and management of the company.

- Promote a regime where professional investors seek multiple proxy advisors if they are going to rely on proxy advisors. The SEC should seek to discourage abdication of voting decision to any third party.

Proxy Advisory Firms

- Proxy advisory firms should track the operating, financial and strategic performance of issuers continuously, so that recommendations are made in the context of how the company is being managed, not just solely on the basis of isolated analysis of a particular issue or stated governance policy standard.

- Proxy advisors should communicate all possible positive and negative consequences should their recommendations result in a vote against management in a manner similar to forward-looking risk factors.

- Proxy advisors should quantify (where possible) the dollar value of issues to which they recommend a vote "against" a management proposal.

- Proxy advisor methodologies should be transparent and made available to issuers at no charge, so that clients can better evaluate their recommendations and issuers can better react and modify governance procedures through a due process model.

- Proxy advisors should fully disclose all sources of possible conflict in sufficient detail to allow assessment of their independence and should recuse themselves when clear conflicts exist.

- Proxy advisors should maintain records and certify their voting to their clients.

Over-Voting and Under-Voting (Imbalances & Allocation)

NIRI believes the issue of voting imbalances created by under- and over-voting is important for the SEC to consider acting upon in order to ensure the voting integrity of our proxy system and to ensure all shareholders are treated equally. As the SEC has indicated, some securities intermediaries, typically broker-dealers, have developed methods to reconcile their records and allocate votes to their customers. However, these methods are not regulated by the SEC or any self-regulatory organization, and discrepancies occur regularly.

The concept release asks whether broker-dealers should be required to disclose the allocation method used and the likely effect of that method on whether customer voting instructions would actually be reflected in the broker-dealer's proxy sent to the vote tabulator, and whether the SEC should require the use of a particular allocation method.

In response, NIRI believes:

- The use of one allocation method for all broker-dealers would help to standardize the practice, providing a platform that the SEC could monitor and offering greater transparency to both shareholders and issuers.

- In turn, this will help manage discrepancies related to under- and over-voting, and may lead to improved reporting timelines and increased efficiencies.

The concept release notes, "the lack of empirical data on whether over-voting or under-voting is occurring and if so, to what extent." NIRI believes this information should be collected from proxy participants in order to evaluate appropriate regulatory responses. NIRI also suggest the SEC broaden the focus beyond annual shareholder meetings to include M&A and other proxy contests. This may provide the most interesting and useful data.

To illustrate a voting discrepancy scenario, one issuer provided the following example of incorrect voting tabulation:

- During an annual shareholder meeting in 2008, Broadridge sent the issuer's proxy tabulator a 15-day vote assessment. This assessment included approximately four million shares from a large institutional shareholder, who happened to manage the issuer's 401(k) plan. The four million shares were therefore reported as broker non votes **in error**.

- Under the 401(k) plan provisions, shares are voted two days before the shareholder meeting by the trustee of the 401(k) plan shares. The proxy tabulator informed Broadridge that the institution **over-voted** the trustee's position, and that the four million shares were related to the 401(k) plan. The proxy tabulator set aside these four million shares for the plan so they would be voted by the trustee at the designated time – two days before the shareholder meeting.

- At the designated time, the institution and 401(k) manager sent the plan vote to Broadridge, but Broadridge showed the trustee's position as fully voted. Therefore, Broadridge did not pass the vote to the proxy tabulator for inclusion.

- At the issuer's annual shareholder meeting, upon reviewing the final vote, the issuer noticed a discrepancy of approximately four million shares, and notified the institution/401(k) plan manager immediately following the meeting. The proxy tabulator subsequently corrected the vote and sent the revised tabulation report to the issuer with the plan votes correctly applied.

NIRI believes there were two failures in the system:

- The company's 401(k) position was over-voted and not corrected by Broadridge when notified by the proxy tabulator. The issuer indicates this was addressed with Broadridge management immediately after the annual meeting.

- The proxy tabulator should have confirmed the plan vote prior to the meeting. The issuer also addressed this with the proxy tabulator when the situation occurred.

This example also highlights two related issues on which the Commission seeks comment - vote verification and access to shareholder lists. NIRI believes requiring vote tabulators, securities intermediaries and proxy service providers to provide each other with access to vote data so investors and issuers can confirm that votes have been received and tallied according to investor voting instructions would help to eliminate similar situations. This would also begin moving

toward the end-to-end vote confirmation important to restoring voting integrity in our proxy system and confidence in our capital markets.

NIRI also believes individual shareholders should not have the ability to conceal their identity through OBO status, especially when this creates an unequal situation for shareholders and may disadvantage some types of shareholders. NIRI particularly believes this may be the case with hedge funds, as an example, as they are not regulated nor appear to be held to the same filing standards as pension and mutual funds at all times. NOBO/OBO recommendations are covered more fully in the "Issuer Communications with Shareholders" section of this comment letter. However, on this subject of institutional shareholder filing standards, NIRI fully supports the recommended improvements outlined in the SEC Office of Inspector General's report, "Review of the SEC's Section 13(f) Reporting Requirements," dated September 27, 2010 and believes these should be implemented immediately.

Vote Confirmation

NIRI supports shareholders' ability to confirm proxy vote acceptance, another key step in bolstering U.S. proxy system voting integrity. Therefore, NIRI supports a cost-effective process to ensure proxy vote confirmation is communicated to shareholders. NIRI does not support a costly system borne by issuers and ultimately shareholders to provide *individual* vote confirmation without further study that finds this is necessary due to problems within the proxy system.

Proxy Voting by Institutional Security Lenders (Notice & Disclosure)

NIRI supports disclosure of all information, including meeting agendas, to aid shareholders in evaluating the termination of security lending so they may vote their proxy. However, NIRI believes that this is not a practical possibility in the current system due to the time and process necessary for the development of agenda items outside of management's control.

Proxy Distribution Fees

Voting on corporate governance matters is a fundamental right of all U.S. shareholders. Similarly, proxy distribution is a fundamental obligation of U.S. issuers. NIRI appreciates the SEC evaluating a proxy distribution system that was designed when only about 25 percent of a company's stock was held in street name, and that pre-dates much of the technological innovation over the last thirty years. Companies are directly responsible for costs or selecting service providers for servicing registered shareholders. However, today most companies' shareholder bases consist of approximately 75 to 80 percent registered in street name and the large bulk of issuer proxy costs are for these holders. Companies must reimburse broker-dealers and their service providers for costs related to proxy distribution. The Shareholder Communications Coalition, of which NIRI is a member, will comment specifically on this area

and other issues outlined in this concept release. However, NIRI's position on two issues concerning this subject follows:

- First, NIRI believes the many corporate governance provisions of the recent Dodd-Frank legislation increase the urgency of this review, and serve to highlight the need for a proxy system that is accurate, cost-effective and without the potential for error. The street name aspect of the proxy system is unique and of tremendous importance to corporate governance. Street name holders are in many cases (OBOs) unknown to issuers making direct communications impossible. As we move toward an environment of greater shareholder influence on corporate governance matters, the ability of companies to know these holders, communicate directly with them and encourage them to vote becomes a high priority, particularly in close vote situations or even to achieving quorum. In a world of global investors, impacted by changes in technology, trading and volatility, improving our complex proxy system is an issue of global competitiveness for U.S. capital markets and corporations. NIRI urges the SEC to commission an independent third party audit of the current fee structure as recommended by the NYSE Proxy Working Group several years ago. This audit would evaluate all cost components of the proxy system in order to ensure that costs are being properly allocated and reimbursed by issuers. As the entire U.S. proxy system, from shareholder to issuer, becomes more transparent and verifiable, it seems fitting that an independent examination of fees would verify that "pass through" costs are just that.

- Second, NIRI believes it is inappropriate for the NYSE to set proxy distribution fees given the evolution of the markets and the growing disconnection of trading from listed company services. This role, in NIRI's opinion, should be held by a disinterested, independent regulatory body such as the SEC or FINRA.

Issuer Communications with Shareholders

Issuer/shareholder communications is the primary responsibility of the corporate investor relations professional. In this section, NIRI responds to several of the SEC's questions and highlights challenges faced by issuers in effecting this communication. These communication challenges negatively impact all shareholders, particularly individual shareholders, creating unnecessary inequity among shareholders that is resolvable. Resolving these challenges will benefit all shareholders through better information and, ultimately, the ability to make informed decisions regarding the securities they hold. NIRI looks forward to further action in this critical area.

In the concept release, the SEC seeks comments from issuers on whether current rules (including NOBO/OBO classification) inhibit communication, the adequacy of communication under the current system and the benefit of issuers being able to identify shareholders (including any privacy considerations that might arise from the disclosure of ownership stake). Despite a strong desire among issuers (and reasonable and appropriate requirements by the SEC for issuers) to communicate directly with all of their shareholders, this rarely happens outside of the annual proxy process.

The current system of holding securities in street name creates a challenging environment for issuers to directly communicate with their shareholders. While the efficiency of clearing transactions through the NSCC and registration with DTCC are clear, the current structure makes it largely impossible for issuers to know their street name shareholders and makes communication with them inefficient, inconsistent and expensive.

Despite significant technology improvements enabling all equity positions to be compiled daily, it takes at least one week for companies to identify their typically smallest group of shareholders (NOBOs) (at least five days for intermediaries to respond [14a-13(b)(2)]). Further, access to full beneficial owners requires significant cost and generally well over a month to request, process and receive a shareholder list based on a specific record date. As noted earlier, an estimated 75 to 80 percent of all shares are held in street name; with 75 percent of those shares generally held by OBOs, the beneficial owners of approximately 52 to 60 percent of publicly held companies' shares are unknown. Therefore issuers are unable to make timely, cost effective direct contact with the majority of their holders.

The OBO/NOBO distinction is an impediment to issuers' direct shareholder communications with three significant implications:

1) Issuer/shareholder Engagement and Information Flow

    - Given the rise in the number of meaningful and contested voting matters, companies have a clear, reasonable need to communicate directly with shareowners. Without dialogue, there is a risk of devolving to a "squeaky wheel" market where the most vocal minority stakeholder promotes special interests, potentially over the best interest of all shareholders.

    - A historical and recent objective of increased regulation, through legislation such as Dodd-Frank and SEC rulemaking, is improving corporate governance. This outcome is easily achieved (at lower cost to the public) through increased direct communication between companies and their ultimate owners.

    - As noted in the House Report for the Shareholder Communications Act of 1985: Informed shareholders are critical to the effective functioning of U.S. companies and to the confidence in the capital market as a whole. When an investor purchases common stock in a corporation, that individual also obtains the ability to participate in making certain major decisions affecting that corporation. Fundamental to this concept is the ability of the corporation to communicate with its shareholders.

2) Shareholder Participation

    - The current proxy process is complex and widely believed to be misunderstood.

    - Retail shareholder participation in proxy voting has been declining. As rules become more complex, and disclosure more complex and voluminous, voter participation may continue to decline.

- While anecdotal, there is a perception among retail shareholders with small or modest positions that their vote doesn't count. Under the current system, an issuer's primary tools to encourage voter participation include general educationally oriented communications and the use of a proxy solicitor, which is expensive and may or may not be effective.

- Proposed advanced voting instructions as discussed in the concept release are an interesting tool for consideration. Advanced voting instructions have the potential to address some of the quorum and retail vote reduction issues resulting from eliminating broker voting (NYSE Rule 452 amendment). However, it appears to be missing a method for investor education, thus potentially having the opposite effect of exacerbating the decline in retail voting. It may simply mask the underlying issue of low retail shareholder engagement by providing a vehicle for "bulk" voting and be a disincentive for shareholders to access and evaluate specific proxy proposals. These unintended consequences should be considered, especially in complex proxy vote situations where one-size truly does not fit all. Additionally, advance notification or duel record dates will have additional associated costs that could overly burden issuers.

- Educating shareholders is a crucial part of soliciting their participation, particularly at the retail level. All parties to the proxy system – issuers, exchanges, broker-dealers, regulators and service providers play a role in educating investors. NIRI believes that unbiased education will become increasingly important as new corporate governance rules take effect and disclosure complexity increases.

- Our current system segregates investors between registered and beneficial owners. The beneficial owners, whom issuers have the most difficulty communicating directly with, have the lowest proxy voting participation.

3) Cost

- Under the current framework, issuers must pay brokers or banks and their agents for distributing proxies and NOBO lists. A company must not only pay the actual distribution costs, but also an additional fee for these services, costs that are ultimately borne by all shareowners. If a shareowner's OBO status makes a company's communications more expensive, that additional cost is subsidized by *all* shareholders creating investor inequality that is antithetical to the SEC's investor equality mandate.

- The practical effect of this expensive, time-consuming process may be to deter shareholder communications beyond the minimum required by regulation.

The OBO/NOBO distinction appears rooted in history rather than necessity or investor preference. A survey undertaken in 2006 on behalf of the NYSE Proxy Working Group revealed that only 36 percent of retail customers would choose to be OBOs if they understood the consequences. This percentage declined to 14 percent if a $25 annual fee were charged to maintain OBO status and to five percent if the annual fee were $50.

With these comments in mind, we ask the SEC to consider these recommendations:

- Eliminate the OBO/NOBO classification and implement SEC rulemaking to permit issuers to communicate directly with their shareholders. Allow for a nominee/custody arrangement, (as outlined by the Shareholder Communications Coalition), enabling holders wishing to remain anonymous to do so. This would protect their privacy interest (at their own expense), and preserve investor equality.

- Ensure issuer costs are minimized so companies may effectively and efficiently communicate directly with shareholders. Direct issuer-shareholder communications are central to fostering greater proxy voting participation, which NIRI believes should be the primary goal of any SEC rulemaking in this area.

Shareholder education is important and should be the cornerstone of informed decision making, and issuers are in the best position to provide this education. Providing issuers with direct-to-shareholder access would facilitate this process and invite an open and more robust dialogue between the issuer and their shareholders.

Means to Facilitate Retail Investor Participation

As discussed in previous sections, the current proxy system is overly complex, requiring considerable investment in terms of time and expense to ensure adequate voter turnout and resolution ratification. While the burden of garnering shareholder support to ratify resolutions falls on the issuer, the process of achieving this objective is complicated by the challenge in simply generating the requisite voter participation.

One issue commonly cited in this discussion is Notice and Access ("N&A"). N&A offers issuers potential benefits such as the potential for certain expense reductions and efficiencies; however, N&A may also result in lower voter turnout, particularly among retail shareholders, which could negatively influence quorum. Even when quorum is achieved, a less-than-full turnout can sway the outcome of a particularly contentious resolution or suggest negative shareholder opinion.

NIRI believes there is a need for better investor education regarding the use of N&A, voting obligations and the investors' role in corporate governance. Investors need to better understand their voting classification (NOBO/OBO) if these systems are to be maintained. The websites used for shareholder voting, regardless of whether they are supported by the issuer, the N&A provider or the broker-dealer, have the potential to further complicate investors ability to vote if they do not understand their classification.

The N&A proxy card or VIF may be perceived by some to be in an investor non-friendly format. Additionally, the process of voting is disconnected from the proxy information that describes the resolutions. NIRI suggests providing links during electronic voting to the various resolutions so that investors may toggle as necessary to ensure they cast informed votes. Brokers should also allow clients to use the same platform for all of their proxy voting. Collecting voter instructions could be accomplished on this same platform rather than requiring voters to visit multiple sites when they own multiple securities.

Other issues raised in this section of the concept release related to increased use of issuer websites for education purposes. While NIRI agrees this is a critical repository for investor information and SEC provided education, this should not be considered the best and only method for educating investors. For example, as most shares are held in street name, broker websites may be the logical destination for street name holders seeking information.

Data Tagging Proxy-Related Materials

NIRI believes this topic requires a great deal more study regarding implementation costs versus benefit. Recent SEC requirements for XBRL tagging of EDGAR financial filings has, in the opinion of many issuers, created a great deal of additional expense (ultimately borne by shareholders) while also requiring additional time and effort to ensure successful tagging and filing, without any measurable increase in financial statement usability. Anecdotally, shareholders have not indicated any appreciation for XBRL-tagged financial statements nor is there any quantifiable evidence to suggest that shareholders would appreciate an XBRL style tagging of any proxy-related data (or which proxy-related data is preferred). To NIRI's knowledge, there are no studies indicating that XBRL-tagged financial information leads to more effective shareholder engagement or increased transparency. Based on discussions with issuers, there is no indication of broad investor interest in data-tagged financial information, and issuers indicate that, in fact, many investors are unaware of XBRL.

One argument for XBRL tagging of financial statements was based upon the promise of easy financial information comparison via applications that private industry would develop. Unfortunately, we haven't seen user demand for this regulatory mandate, and to date, costs appear to outweigh any benefit. And while it seems intuitive that standardizing financial information (numbers) may enhance comparability, the potential to somehow standardize text that is inherently unique from company to company requires a much greater leap of faith. Unfortunately for issuers and their shareholders, imposing another such new requirement will represent the incursion of real costs for the promise of something there is no demand for now, and based on experience to date with financial information, there is unlikely to be a demand for in the future.

The SEC should ensure that any further data tagging costs imposed upon issuers and their shareholders are based on specifically identified investor needs, and that this action will be effective in meeting such need. NIRI does not support further costs without such research and cost justification.

"Empty Voting" and Related "Decoupling" Issues

NIRI agrees that decoupling raises potential practical and theoretical considerations for share voting which may enhance or undermine the interests of issuers and their shareholders. In an effort to provide an environment of shareholder equality, NIRI recommends the SEC continue to gather data on empty voting practices and techniques to better understand its actual use, while targeting regulatory action primarily on the timing of release of the meeting agenda.

While NIRI favors increased transparency with regard to intent, the most effective near-term action will focus on disclosure of the shareholder or special meeting agenda sufficiently ahead of the record date to enable investors who have loaned their securities to recall their loans and retain voting control. It is often difficult for shareholders to learn what matters will be voted on at a meeting until the relevant proxy statement is distributed, which is generally not until after the record date for the meeting has occurred.

NIRI agrees that a disconnect between voting and economic rights has existed since the ability to borrow shares. Empty voting can be, and may have been used by investors with individual "agendas" to influence proxy voting in a way that is not representative of the majority of shareholders.

Conclusion

NIRI is pleased to provide these comments to the SEC as it deliberates changes to the U.S. proxy system. It is critical that we have an effective proxy system that is free from conflicts of interest and that allows for timely, efficient and understandable shareholder communications. Equally important is a proxy system that is transparent and accurate to ensure equality among shareholders. NIRI stands ready for further discussion regarding any of the suggestions or comments made in this public comment letter, or about actual shareholder communication practices of the investor relations professional.

Thank you for your consideration on this important matter.

Sincerely,

Jeffrey D. Morgan, CAE
President & CEO

SOCIETY OF CORPORATE SECRETARIES & GOVERNANCE PROFESSIONALS

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DISCUSSION DRAFT
3/4/2010

Proxy Advisory Services: The Need for More Regulatory Oversight and Transparency

Institutional investors are generally required by law to vote the shares in their portfolios, and the result is that close to 100% of institutional holdings are always voted at the annual and special shareholder meetings of public companies.

Institutional investors often hire third-party investment managers to invest and trade their portfolio securities, and the institutions (and their investment managers) similarly hire third-party proxy advisory firms to help them vote their proxies in shareholder elections. These firms offer vote recommendations—or are given direct voting authority—on proposed corporate directors, as well as management and shareholder proposals.

In some cases, proxy advisory firms work with their clients to develop unique voting guidelines that will be applied by the advisory firms, as a part of the services provided. However, more often than not, the clients accept the voting guidelines or policies developed by the proxy advisory firms. While an individual proxy advisory firm may receive input from its clients in the development of a particular voting policy, the reality is often that the proxy advisory firm suggests the policy and voting patterns at companies suggest that many institutions vote according to those policies.

The end result of this process is not a unique set of voting instructions for each institutional client, but a set of guidelines and policies that have been developed by the proxy advisory firm and are used by most of the firm's clients. At a number of proxy advisory firms, these guidelines do not evaluate the facts and circumstances of each public company with respect to the matters to be voted on; instead, these guidelines encourage a "one-size-fits-all" or "check the box" methodology.

We believe that widespread use of proxy advisory services by institutional investors has resulted in these firms having a significant impact on shareholder voting. However, proxy advisory firms remain largely unregulated, and are not fully transparent about their methodologies and decision-making processes.

For the reasons outlined in this Discussion Draft, the Securities and Exchange Commission (SEC) should review the role of proxy advisory services and the processes used by these firms in generating voting recommendations and making voting decisions. We believe that investors may not be protected adequately because of the current deficiencies in regulatory

oversight and transparency that exist within the proxy advisory industry. The recommendations in this Discussion Draft are offered as a starting point for policy deliberations about how best to improve the regulatory oversight and transparency of proxy advisory firms, in order to protect investors.

The Proxy Advisory Industry

There are at least six firms offering proxy advisory services: (1) RiskMetrics Group (ISS); (2) Glass Lewis & Co.; (3) Egan-Jones Proxy Services; (4) Marco Consulting Group; (5) Proxy Governance, Inc.; and (6) CtW Investment Group.

Of these six firms, RiskMetrics is the largest, with more than 1,700 institutional investor clients. Three of the six firms—RiskMetrics, Marco Consulting Group, and Proxy Governance, Inc.—are registered with the SEC as investment advisers under the Investment Advisers Act of 1940.

Proxy advisory firms may significantly influence many director elections and corporate actions, as their institutional clients—primarily mutual funds and pension plans—have large stock holdings compared to other investors. And this influence is only going to increase with the recent change to New York Stock Exchange (NYSE) Rule 452, regarding broker discretionary voting. The Rule 452 amendment also will significantly reduce the influence of retail investors in the proxy process.[1]

Unfortunately, several proxy advisory firms are not subject to any regulatory oversight, required disclosures, or fiduciary obligations regarding their ability to control or influence the outcome of shareholder votes at public companies in the United States.

Regulatory Problems within the Proxy Advisory Industry

Current laws impose fiduciary responsibilities on investment companies, investment advisers, and most retirement and pension plans in voting their proxies. Pursuant to SEC rules adopted in 2003, investment companies and investment advisers are now required to adopt policies and procedures to ensure that proxies are voted in the best interests of their shareholders and clients.[2] Similarly, the Employee Retirement Income Security Act of 1974 (ERISA) has been interpreted by federal regulators as imposing fiduciary obligations to vote proxies for stocks owned by ERISA retirement and pension plans.[3]

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[1] On July 1, 2009, the SEC approved an amendment to NYSE Rule 452 which will prohibit brokers from having the discretion to vote uninstructed shares of beneficial owners in uncontested director elections. This rule change, which is effective as of January 1, 2010, is expected to significantly reduce the number of retail votes cast in director elections.

[2] Disclosure of Proxy Voting Policies and Proxy Voting Records by Registered Management Investment Companies, SEC Release No. IC-25922, 68 Fed. Reg. 6,564 (February 7, 2003), available at http://www.sec.gov/rules/final/33-8188.htm; and Proxy Voting by Investment Advisers, SEC Release No. IA-2106, 68 Fed. Reg. 6,585, available at http://www.sec.gov/rules/final/ia-2106.htm.

[3] Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, U.S. Department of Labor, 19 C.F.R. § 2509.94-2, available at http://www.dol.gov/dol/allcfr/Title_29/Part_2509/29CFR2509.94-2.htm.

Many institutional investors and their third-party investment managers—particularly mid-size and smaller investment managers—do not have in-house staff, or have limited in-house staff, to analyze and vote on proxy items, and so they outsource their voting decisions to proxy advisory firms. For example, SEC rules require mutual funds to publicly disclose their proxy voting records. In response, many funds now outsource their voting decisions to proxy advisory firms, and, in a number of cases, they generally adopt the voting policies developed by one or more of the advisory firms. Outsourcing of proxy voting decisions may result in a "one-size-fits-all" approach that does not encourage voting decisions to be reached on a case-by-case basis, taking into account the particular circumstances of a company.

At least one proxy advisory service—RiskMetrics—provides corporate governance and executive compensation consulting services, in addition to providing voting recommendations on proposals submitted in shareholder elections. For example, RiskMetrics offers a consulting service to help companies determine if their equity plans meet RiskMetrics' approval criteria; and it provides a service to evaluate "corporate sustainability," which involves a review of certain environmental and social issues facing a company. Particularly as the SEC reviews its corporate disclosure requirements on these topics—and sustainability advocates increase their advocacy of specific shareholder proposals—this may create conflicts of interest between RiskMetrics' servicing of its institutional clients and the corporate consulting services it also provides.

In addition, a conflict of interest affecting all proxy advisory firms may arise when an institutional client of a proxy firm is also the proponent of a specific proposal—or instigates a "vote no" campaign against directors—that will be subject to a voting recommendation by that same proxy firm. The SEC should evaluate whether a conflict of interest exists when an advisory firm develops a particular position from its governance model, one of its institutional clients becomes a proponent of the position through a shareholder proposal on the proxy of a public company, and then the advisory firm recommends support (or actually votes shares) for that position among the firm's other institutional clients.

The New York Stock Exchange Proxy Working Group Report

In 2006, the New York Stock Exchange Proxy Working Group released a report on the proxy processing system. One of the recommendations of the Working Group was a request that the SEC study the role of proxy advisory firms on account of their growing power over the voting of corporate shares in the United States:

> As a part of its analysis of the proxy system, the Working Group heard a great deal of concern expressed about the increasing role and influence of shareholder voting advisory services in the proxy system. These services often have multiple roles in the proxy process, including advising issuers on various governance issues, making recommendations to institutions and other shareholders on how to vote and actually voting the shares of numerous institutions that choose to outsource their voting decisions. In light of these concerns, the Working Group

recommends that the NYSE request the SEC to study the role these groups play in the proxy voting process.[4]

The Government Accountability Office Study

In June 2007, the U.S. Government Accountability Office (GAO) conducted a study to evaluate conflicts of interest that may exist with proxy advisory firms and the steps that the SEC has taken to oversee these firms.[5]

This GAO study noted that certain industry associations and academics were critical of the potential conflicts of interest which exist among these proxy advisory firms. Specifically, this GAO study identified four potential (or actual) conflicts:

- The business model of RiskMetrics, which includes providing consulting services to corporations on their corporate governance. Critics of this practice contend that corporations may feel obligated to obtain these consulting services in order to secure favorable vote recommendations; this is particularly true in the case of equity plans proposed for shareholder approval, which must first "pass muster" under RiskMetrics' proprietary model.

- Owners or executives of proxy advisory firms may have a significant ownership interest in, or serve on the board of directors of, corporations that have proposals on which the firms are offering vote recommendations.

- Institutional investors may submit proposals to be voted on at shareholder meetings, raising concerns that proxy advisory firms will make favorable recommendations to other institutional clients on such proposals to maintain the business of the investor clients that submitted these proposals.

- Several proxy advisory firms are owned by companies that offer other financial services to various types of clients, as is common in the financial services industry, where companies often provide multiple services to different types of clients.

At the time of the release of this GAO study, the SEC had not identified any major violations in its oversight of those proxy advisory firms registered as investment advisers. However, the study's authors limited their research to a review of the academic literature and interviews with the SEC and a select number of institutional investors. The study's authors did not ascertain the views of the issuer community, or other stakeholders and interested parties in the proxy voting process.

SEC Compliance Examinations

[4] Report and Recommendations of the Proxy Working Group to the New York Stock Exchange, June 5, 2006, p. 29, available at http://www.nyse.com/pdfs/PWG_REPORT.pdf.

[5] Government Accountability Office, GAO-07-765, Corporate Shareholder Meetings: Issues Relating to Firms That Advise Institutional Investors on Proxy Voting (June 2007), available at http://www.gao.gov/new.items/d07765.pdf.

More recently, the SEC has inquired about the role of proxy voting services, as it conducts compliance examinations of registered investment advisers and mutual funds.

In a Compliance Alert issued in July 2008,[6] the SEC highlighted several deficient practices by some advisers and funds, including:

- Internal controls by investment advisers and funds—required to ensure that the recommendations of proxy advisory firms are consistent with fund governance policies and procedures—were inadequate.
- A lack of proper documentation by investment advisers in their review of conflicts of interest at proxy advisory firms employed by them.
- The discovery of inadequate public disclosures of: (1) the availability of fund proxy voting policies and procedures, and (2) the actual proxy voting records of certain funds.

These SEC compliance findings suggest that more attention needs to be devoted to the regulatory framework for proxy advisory services, in order to improve investor protection.

Academic Studies on Proxy Advisory Services

A number of academic studies and reports have been conducted on the proxy advisory industry. Some of these studies and reports have been critical of the "one-size-fits-all" governance ratings that are used by some of the proxy advisory firms to evaluate corporate performance.[7] Other studies and reports identify problems within the proxy advisory industry, and recommend policy and regulatory solutions.

The Millstein Center for Corporate Governance and Performance at the Yale School of Management has developed two policy briefing papers about the proxy advisory industry. These policy papers contain recommendations for addressing conflicts of interest and other problems with the current structure of the industry:

- Voting Integrity: Practices for Investors and the Proxy Industry.[8] This 2008 working draft by Millstein Center Visiting Research Fellow Meagan Thompson-Mann discusses the processes by which investors make voting decisions and provides a draft code of professional practices for the proxy advisory industry.

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[6] Securities and Exchange Commission, ComplianceAlert (July 2008), available at http://www.sec.gov/about/offices/ocie/complialert0708.htm.

[7] Two of the more prominent papers and studies on this subject are: (a) Sanjai Bhagat, Brian Bolton and Roberta Romano, The Promise and Peril of Corporate Governance Indices, 108 Colum. L. Rev. 1803 (2008), available at http://www.columbialawreview.org/assets/pdfs/108/8/Bhagat_Bolton_Romano.pdf (concluding that there is no consistent relationship between corporate governance indices and future corporate performance and that the most effective approaches to governance depend on context and a company's specific circumstances); and (b) Robert Daines, Ian Gow and David Larcker, Rating the Ratings: How Good Are Commercial Governance Ratings?, Arthur and Toni Rembe Rock Center for Corporate Governance, (2008), available at http://www.gsb.stanford.edu/cldr/cgrp/documents/dgl6-26-2008.pdf (concluding that the level of predictive validity of corporate governance ratings is well below the threshold necessary to support claims about the ability of ratings to predict future corporate performance and risk).

[8] Millstein Center for Corporate Governance and Performance, Policy Briefing No. 2/Voting Integrity: Practices for Investors and the Proxy Industry (June 5, 2008), available at http://millstein.som.yale.edu/2008%2006%2005%20voting%20integrity2.pdf.

- Voting Integrity: Practices for Investors and the Global Proxy Advisory Industry.[9] On March 2, 2009, a second paper was released by the Millstein Center on the practices of the proxy advisory industry. This paper recommended the development of an industry-wide code of ethics and urged the SEC to take steps to modernize the U.S. proxy voting system.

Other academic papers released in 2009 have highlighted the lack of accountability and oversight enjoyed by the proxy advisory industry, under current SEC rules.[10] As with the recent SEC compliance findings noted above, these academic papers highlight the need for improved regulatory oversight and transparency of proxy advisory firms.

Recommendations for Improving the Regulatory Oversight and Transparency of the Proxy Advisory Industry

The following recommendations are offered as a starting point for policy deliberations about how best to improve the regulatory oversight and transparency of proxy advisory firms, in order to protect investors:

1. Regulatory Oversight of the Proxy Advisory Industry. Proxy advisory firms should be subject to more robust oversight by the SEC. At a minimum, all proxy advisory firms should be required to register as investment advisers, and the SEC should develop a unique regulatory framework for these firms under the Investment Advisers Act of 1940.[11]

SEC regulation should require conflicts of interest disclosure for proxy advisory firms. New SEC regulations should include minimum standards of professional and ethical conduct to be followed by the proxy advisory industry. One of these standards should ensure that a proxy advisory firm publicly discloses its relationship with any client who is the proponent of a proxy proposal or "vote no" campaign, whenever the proxy advisory firm is issuing a recommendation to other clients in favor of the same proposal or "vote no" campaign.

SEC regulation should address whether a proxy advisory firm should be allowed to offer consulting services to any public company for which it is providing recommendations on how investors should vote their shares. Alternatively, if a proxy advisory firm is allowed to offer consulting services to public companies, there should be a complete and total separation of the

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[9] Millstein Center for Corporate Governance and Performance, Policy Briefing No. 3/Voting Integrity: Practices for Investors and the Global Proxy Advisory Industry (March 2, 2009), available at http://millstein.som.yale.edu/Voting%20Integrity%20Policy%20Briefing%2002%2027%2009.pdf (hereinafter "Millstein Policy Briefing No. 3").

[10] See Tamara C. Belinfanti, The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control, 14 Stan. J.L. Bus. & Fin. 384 (2009); and Stephen Choi, Jill Fisch and Marcel Kahan, Director Elections and the Role of Proxy Advisors, 82 S. Cal. L. Rev. 649 (2009), available at http://weblaw.usc.edu/why/students/orgs/lawreview/documents/ChoiforWebsite.pdf.

[11] See 15 U.S.C § 80b-1 et seq. For example, the Investment Advisers Act imposes a fiduciary duty on investment advisers to act in the best interests of their clients by fully disclosing all potential conflicts of interest. See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 192-93 (1963) ("The Investment Advisers Act thus reflects … a congressional intent to eliminate, or at least to expose, all conflicts of interest which may incline an investment adviser—consciously or unconsciously—to render advice which was not disinterested.").

proxy advisory business from all other businesses of a proxy advisory firm, including consulting and research services.

As the SEC develops a regulatory framework for proxy advisory firms, one possible avenue for guidance is the current and evolving regulation of credit rating agencies, also called Nationally Recognized Statistical Rating Organizations (NRSROs). A review of the SEC and staff actions with regard to NRSROs during the past two years shows that there are numerous and significant analogies with regard to problematic practices and regulatory improvements that should be considered for proxy advisory services.[12]

2. Public Disclosure of the Proxy Governance Models Used by Advisory Firms. Proxy advisory firms should be required to publicly disclose their internal procedures, guidelines, standards, methodologies, and assumptions for developing voting recommendations and voting decisions.

These disclosures would permit investors and independent third-parties to reconstruct, evaluate, and critique the advice rendered by proxy advisory firms.[13]

3. More Robust Due Diligence Regarding Proxy Vote Recommendations. Institutional investors with fiduciary duties to clients, beneficiaries, or shareholders should be required to exercise greater oversight responsibility with respect to any delegation, either expressly or implicitly, of their voting rights to a proxy advisory firm. The SEC and the Labor Department should consider establishing a more robust due diligence process for institutional investors, so that proxy voting enjoys a more important role in the investment process and within the fiduciary responsibilities of these investors.

As a part of their due diligence process for making proxy voting decisions, institutional investors should utilize, whenever appropriate, methodologies that evaluate the facts and circumstances of each public company and avoid "one-size-fits-all" or "check the box" methodologies.[14] Institutional investors should disclose these methodologies (including any voting guidelines provided to a proxy advisory firm) on their websites, for the benefit of their shareholders, clients, or beneficiaries. These disclosures also will help public companies evaluate their individual governance practices against the policies of their institutional shareholders.

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[12] See, e.g., http://www.sec.gov/news/press/2009/2009-200-factsheet.htm.

[13] Some commentators have urged that any public disclosures by proxy advisory firms use the XBRL interactive data format. The SEC should also require greater transparency of the internal procedures, guidelines, standards, methodologies, and assumptions used by proxy advisory firms to develop corporate governance ratings.

[14] Millstein Policy Briefing No. 3, at 6, supra note 9, discussed the underlying tension between an evaluation of the individual circumstances of a company and a more detailed, rules-based approach that requires fewer resources ("Debate in this area centered on whether it is more appropriate on the one hand, for investors and their advisors to develop general policies that are relatively flexible and then adjusted to fit the individual circumstances of the company under consideration; or on the other hand, to have far-reaching and detailed policies that generate consistent recommendations which allow possibly under-resourced proxy voting teams to vote without spending too much time considering the vote in the greater context of individual performance. When the proxy team is small, or governance resources sparse, this becomes a crucial issue.").

4. Public Disclosure of Proxy Voting Recommendations and Decisions. Proxy advisory firms should be required to maintain a public record of all their voting recommendations and voting decisions. All institutional investors using proxy advisory services—including pension funds, hedge funds, and private equity funds—should publicly disclose the actual proxy votes cast by them (or on their behalf), if they are not already disclosing their voting records.

Proxy advisory firms should be required to disclose the underlying data, information, and rationale used to generate a specific voting recommendation or a voting decision. As noted earlier, when recommending in favor of stockholder proposals or "vote no" campaigns submitted or initiated by their clients, proxy advisory firms should be required to disclose their relationships with those clients.

5. Public Company Input into Advisory Recommendations. Proxy advisory firms should be required to allow public companies sufficient opportunity to review draft reports for accuracy and to respond to comments or recommendations with which they do not agree. Advisory firms also should disclose to their clients (and disclose publicly) any public company's response to their voting recommendations or analysis.

6. Public Disclosure of Voting Errors. Proxy advisory services should disclose publicly and promptly any errors made in executing or processing voting instructions on a particular proxy vote.

Conclusion

We believe that proxy advisory services have an oversized impact on the proxy process. Despite their large role, proxy advisory firms generally remain unregulated and unsupervised and often are not transparent with regard to their standards, procedures, methodologies, and conflicts of interest.

Any evaluation of the proxy voting system by the SEC should include the role of proxy advisory services. The SEC should consider increasing its regulatory oversight of proxy advisory firms through the Investment Advisers Act of 1940. The SEC should require all proxy advisory firms to register as investment advisers, and should develop a regulatory framework that is unique to the proxy advisory industry.

Proxy advisory firms should disclose any conflicts of interest, including relationships with proponents of stockholder proposals and institutions running "vote no" campaigns, as well as any consulting arrangements that are permitted to continue. Proxy advisory firms should be required to publicly disclose their internal methodologies and standards, the information they rely on, and all of their voting recommendations and decisions, as well as the views of companies on their recommendations.

Finally, institutional investors should maintain greater oversight over their relationships with proxy advisory services, consistent with their fiduciary obligations to vote the shares they

own. In this regard, investors should be engaging in a more robust due diligence process, to ensure that they act in the best interests of their shareholders, clients, or beneficiaries.