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October 8, 2013

Elizabeth M. Murphy, Esq.
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: **Petition Related to Proxy Advisory Firms**

Dear Ms. Murphy:

By this Petition, and in accordance with Rule 192 of the Securities and Exchange Commission (the "Commission") Rules of Practice,[1] The NASDAQ OMX Group, Inc. ("NASDAQ"), as a public company and on behalf of many of our clients who are also public companies, respectfully requests that the Commission or its Staff revise the guidance given by Commission Staff nearly ten years ago to proxy advisory firms (the "Firms").[2] Specifically, we request that future reliance on such relief be conditioned on disclosure by the Firms of: (i) the models, formulas and methodologies pursuant to which they evaluate and make recommendations regarding how shareholders should vote on matters presented to them for a vote; and (ii) all relationships that may give rise to conflicts of interest.

As described in this Petition, during the time since these letters were issued, the proxy advisory industry, and the nature of the services Firms provide to investors, has dramatically changed.

[1] 17 CFR 201.192.

[2] In 2003, the Commission amended the Investment Advisers Act of 1940 to address the fiduciary obligation of investment advisers to their clients when the adviser has authority to vote the clients' proxies. (Proxy Voting by Investment Advisers, Release No. IA-2106 (January 31, 2003), 68 FR 6585 (February 7, 2003). In 2004, Commission Staff issued two no-action letters (to Mari Anne Pisarri, September 15, 2004, available at: http://www.sec.gov/divisions/investment/noaction/iss091504.htm and to Kent S. Hughes, May 27, 2004, available at: http://www.sec.gov/divisions/investment/noaction/egan052704.htm), the practical effect of which was to encourage the reliance by investment advisers on the voting recommendations of Firms.

Without question, we recognize that for many investors, with numerous shareholder proposals to consider, the Firms provide a potentially valuable service and in making this request, NASDAQ does not intend to prohibit the Firms' business or harm the institutional investors which rely on their services. However, as they operate today, their services cannot be evaluated in a meaningful manner, including by the shareowners who rely upon them and the companies who are left unsure what it requires to satisfy them. Unless we enable companies and all market participants to have full information about the practices and activities of the Firms, the Firms will continue to exert outsized influence from the shadows in which they operate and profit. Indeed, there is evidence that the Firms not only increase the costs of being a public company, but also create disincentives for companies to become public in the first place. The changes we advocate seek to address these concerns and promote transparency and fairness in this important area, to the benefit of companies, shareholders and the public interest.

Background

In recent years, the share of institutional share ownership has grown significantly, recently encompassing over 75% of share ownership. As a result, institutions are responsible for voting billions of shares.[3] To assist with this responsibility, many institutional investors retain proxy advisory firms. The proxy advisory business is dominated by two firms: Institutional Shareholder Services, Inc. ("ISS") and Glass, Lewis & Co. ("Glass Lewis"). Together, they control approximately 97% of the market for proxy advisory firm services.[4] ISS alone renders millions of decisions for more than 1,000 institutions that vote on proxies, affecting their holdings in 5,000 publicly traded companies. Between them, ISS and Glass Lewis influence the votes of one-fourth to one-half of the shares of the typical mid- or large-cap company.[5] A Stanford University study found that opposition by a proxy advisor results in a "20% increase in negative votes cast."[6] That figure underestimates the power of ISS and Glass Lewis since corporations trying to avoid a negative recommendation from a proxy advisory firm will shape their policies accordingly.[7]

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[3] The Conference Board, 2008 Institutional Investment Report: Trends in Institutional Assets and Equity Ownership of U.S. Corporations (2008). *See also* prepared remarks of Timothy J. Bartl, President, Center on Executive Compensation before a subcommittee of the House Committee on Financial Services on June 5, 2013, entitled "A Case for Greater Oversight of the Proxy Advisory Firm Industry," available at: http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-tbartl-20130605.pdf.

[4] James K. Glassman and J.W. Verret, How to Fix Our Broken Advisory System, Mercatus Center (2013), available at: http://mercatus.org/sites/default/files/Glassman_ProxyAdvisorySystem_04152013.pdf.

[5] *Id.*

[6] David F. Larcker, Allan L. McCall and Gaizka Ormazabal, The Economic Consequences of Proxy Advisor Say-on-Pay Voting Policies (July 2012), available at: https://gsbapps.stanford.edu/researchpapers/library/RP2105.pdf.

[7] Glassman and Verret, *supra* note 5.

Notwithstanding this outsized influence, many of the Firms are unregulated and their recommendations on shareholder votes, and how they arrive at them, are subject to little or no scrutiny or oversight. This is particularly troubling because, as discussed below, relatively little is known about the policies and methodologies used by these firms that underlie the reports and vote recommendations relied on by so many investors. The problems inherent in the Firms' lack of transparency are compounded by the fact that ISS' business model, and Glass Lewis' ownership structure, raise serious conflicts of interest that may potentially influence or compromise their recommendations. Oftentimes, these relationships are undisclosed to, and unknown by, the shareholders, companies and institutions that are directly and substantially impacted by the Firms' recommendations and ratings.

The Firms' outsized influence on corporate governance has significant deleterious consequences. Many companies feel pressured to conform their governance practices to the standards set by the Firms, which may not necessarily coincide with the best interests of the company or its shareholders.[8] And this influence has a further harmful effect: the de facto impact of the Firms' domination is to stifle meaningful debate about corporate governance, particularly scrutiny of their recommendations and the basis for them.

In July 2010, the Commission, recognizing the need to address a variety of issues related to the proxy system, published the Concept Release on the U.S. Proxy System ("Concept Release").[9] In it, the Commission raised a number of questions about the current role of proxy advisory firms and the risks raised by these firms' apparent conflicts of interest as well as the lack of transparency related to the underlying methodologies they use to make recommendations on shareholder proposals. To better understand these issues and risks, the Commission sought public comment.

In response, the Commission received over three hundred comments from a diverse group of respondents, including corporations, academics, attorneys and law firms, advocacy groups, and individuals. Over one hundred of these commenters addressed the current role of proxy advisory firms, frequently citing conflicts of interest and lack of transparency as concerns. Of those comment letters, the majority supported further oversight of proxy advisory firms.

The concern regarding proxy advisory firms has not abated. Earlier this year, the European Securities and Markets Authority ("ESMA"), after seeking comment on the proxy advisory industry, issued a report in which it called for a code of conduct for the proxy advisory industry, noting in particular the need to ensure transparency and disclose conflicts of interest.[10] In June, a subcommittee of the House Financial Services Committee held a hearing on the impact and

8 *See* letter from Tina Davis, Senior Vice President, tw telecom inc. dated October 20, 2010 ("tw telecom Letter"), available at: http://www.sec.gov/comments/s7-14-10/s71410-162.pdf.

9 Release No. 34-62495 (July 14, 2010), 75 FR 42982 (July 22, 2010).

10 ESMA's final report dated February 19, 2013, available at: http://www.esma.europa.eu/system/files/2013-84.pdf.

power of proxy advisory firms.[11] And more recently, the Canadian Securities Administrators, an umbrella group of Canada's provincial and territorial securities regulators, announced that it expects to propose in early 2014 a regulatory approach to proxy advisory firms based on recommended practices and disclosure.[12]

Of note, as described below, several current and former Commissioners have also advocated for increased disclosure by and oversight of Firms. In a recent speech, current Commissioner Daniel M. Gallagher highlighted the need to appropriately oversee and hold Firms accountable for their recommendations:

> I believe that the Commission should fundamentally review the role and regulation of proxy advisory firms and explore possible reforms, including, but not limited to, requiring them to follow a universal code of conduct, ensuring that their recommendations are designed to increase shareholder value, increasing the transparency of their methods, ensuring that conflicts of interest are dealt with appropriately, and increasing their overall accountability. I am not alone in raising these issues, as evidenced by the work in Europe by ESMA regarding proxy advisors as well as by the recent Congressional hearing hosted by Congressman Scott Garrett discussing many of these topics. [footnote omitted] To be clear, I realize that proxy advisors can provide important information to institutional investors and others. However, what European policymakers and our own Congress have highlighted is that changes need to be made so that proxy advisors are subject to oversight and accountability commensurate with their role.[13]

NASDAQ agrees. The time to study this issue has passed. The time to act is now. As more fully described below, the lack of transparency and myriad relationships that give rise to potential conflicts of interest that are rife in the proxy advisory industry demand immediate Commission action. These concerns are serious and their harmful effects on companies and investors are grave. They will not be alleviated without Commission intervention.

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11 Capital Markets and Government Sponsored Enterprises Subcommittee Hearing entitled "Examining the Market Power and Impact of Proxy Advisory Firms", June 5, 2013, See http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=335917.

12 *See* David A. Katz and Laura A. McIntosh, "Corporate Governance Update: The Mainstreaming of Shareholder Activism in 2013," *New York Law Journal*, Sept. 26, 2013, available at: http://www.newyorklawjournal.com/PubArticleNY.jsp?id=1202620793032 (citing CSA Notice 25-301, Update on CSA Consultation Paper 25-401, "Potential Regulation of Proxy Advisory Firms,: Sept. 19, 2013, available at www.osc.gov.on.ca/en/SecuritiesLaw_csa_20130919_25-301_update-25-401.htm).

13 *See* Commissioner Daniel M. Gallagher, Remarks before the Society of Corporate Secretaries & Governance Professionals, 67th National Congress, July 11, 2013, available at: http://www.sec.gov/News/Speech/Detail/Speech/1370539700301.

Lack of Transparency

To state the obvious, transparency is a fundamental tenet of good corporate governance. But notwithstanding recent efforts to become less opaque, this does not appear to be obvious to ISS or Glass Lewis. Indeed, these firms, which provide recommendations on how institutions should vote and, in ISS' case, how companies should govern themselves, are themselves barely transparent regarding the methodologies and models that inform and underlie their recommendations and how they apply them to particular companies and contexts. The Firms' decisions occur privately and there is no real opportunity to review, or even understand, the rationale for their recommendations or how various factors are weighed, if at all.

Not surprisingly, an abundance of the public comments called for increased transparency with respect to the Firms' voting recommendations and how they are reached.[14] As an example, one commenter pointed out that one firm grades public companies on "pay for performance" based on comparisons of companies to peer companies that are not disclosed, using measurements and weighting that are also kept secret.[15] As a result, companies have no basis to evaluate their grade or the peers against which they are rated, determine whether the grade is based on accurate information, and no way to know how to improve their score

Further, because there is no transparency, the Firms' recommendations can be based on inaccurate or misunderstood facts and circumstances, which by itself bears heavily not only on shareholder voting but also the reputation of companies. In this regard, as noted in the public comments, companies are rarely permitted to review reports for accuracy before publication and there is no mechanism to correct mistakes or offer dissenting views.[16]

The Axcelis Letter is illustrative of another problem raised by the lack of transparency and Firms' reliance on so-called proprietary models which they refuse to divulge. In this case, one of the items on the agenda for Axcelis' annual shareholder meeting in May 2013 was a proposal to increase the shares reserved for issuance under the Company's shareholder approved equity incentive plan. To determine its recommendation on such proposals, ISS calculates what it calls a "Company-Specific Allowable Cap" or CSAC for the shareholder value transfer that occurs through grants under such equity plans. ISS maintains that the calculation of CSAC is

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14 *See, e.g.*, letter from John F. Coyne, President, Western Digital Corporation, dated November 15, 2010 ("Western Digital Letter"), available at: http://www.sec.gov/comments/s7-14-10/s71410-271.pdf.; letter from Lynette C. Fallon, General Counsel, Axcelis Technologies, Inc., dated July 19, 2013, available at: http://www.sec.gov/comments/s7-14-10/s71410-322.pdf (the "Axcelis Letter"); and letters from Tom Quaadman, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce, dated September 20, 2010, November 15, 2010, May 9, 2011, September 12, 2011, November 1, 2012, and March 21, 2013, available at: http://www.sec.gov/comments/s7-14-10/s71410-26.pdf. On a related note, one commenter suggested that Firms should disclose the extent to which they have the ability to vote certain shares on behalf of shareholders in accordance with their recommendations. Such information may be material for investors. *See* Western Digital Letter.

15 *See, e.g.*, tw telecom Letter.

16 *See, e.g.*, Western Digital Letter.

proprietary to ISS and does not disclose the formula it uses to make the calculation. Without knowing the CSAC ISS would use for Axcelis, but mindful of the influence ISS has over large institutional shareholders, the Company's board approved what it considered to be a conservative increase to the share reserve for its equity incentive plan, and included such a proposal in its proxy statement. Nonetheless, ISS, in its report issued nine days before the shareholders meeting, recommended a "no" vote on the proposed equity plan increase because, unbeknownst to the Company or any of its shareholders, the proposed increase somehow ran afoul of ISS' proprietary secret formula. In response, the Company immediately engaged ISS in dialog, but could not obtain any details on ISS' methodology or calculation. Upon the advice of a proxy consultant that, without ISS' support, there was little chance shareholders would approve the proposal, Axcelis amended its proposal and ISS changed its recommendation to a "yes" vote.[17] This scenario is oft-repeated during proxy season.

A further concern of commenters and others is the "one-size fits all" approach employed by the Firms and the fact that their recommendations can lack individualized industry and company analysis. For instance, voting recommendations on executive compensation and benefits issues are often made on the basis of generic models, without considering the specific circumstances of a company or the array of reasonable choices among compensation policies and practices.[18] As another example, one commenter noted that the mere presence, or absence, of a particular governance practice could result in a withhold vote for directors, irrespective of the company's rationale for such practice. Further, ISS has announced that, beginning in 2014, it will recommend voting against the election of directors at companies that have not fully implemented majority-approved shareholder proposals. This sort of policy, far from promoting the interests of shareholders of particular companies, in effect substitutes the judgment of proxy advisors for that of the board.[19] Under these circumstances, the Firms' recommendations can be, and often are, arbitrary and inappropriate for particular companies.

The Firms' recommendation with regard to companies' annual "say on pay" votes further illustrates the negative consequences of the Firms' failure to consider individual company circumstances. The Dodd–Frank Wall Street Reform and Consumer Protection Act ("Dodd Frank") provided, among many other things, that shareholders would decide whether the "say on

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[17] Commenters expressed concerns over the short time frame to evaluate and respond to proxy firm reports. *See e.g.*, Western Digital Letter ("At present, issuers are typically given no more than a few days to review and respond to reports and vote recommendations issue by a proxy advisory firm. An extended review and response process will help ensure the factual accuracy of the reports issued and provide shareholders with a more reliable basis to form decisions. … [C]onsideration should also be given to requiring proxy advisor firms to disclose any disagreements with issuers that cannot be resolved and allowing issuers the opportunity to offer a dissenting statement in those instances.")

[18] *See, e.g.*, tw telecom Letter. The approach of BlackRock, Inc., a large asset manager, is illustrative in this regard. It makes its voting decisions independently of the Firms and applies its own guidelines in recognition that good corporate governance is complex and that, from a shareholder point of view, there are different ways to run a company well. *See* http://blackrock.uberflip.com/i/120266/.

[19] *See* Katz and McIntosh, "Corporate Governance Update: The Mainstreaming of Shareholder Activism in 2013," *New York Law Journal*, Sept. 26, 2013.

pay" vote takes place every one, two, or three years. Notwithstanding, ISS and Glass Lewis recommend an annual vote in all circumstances, without consideration of the unique attributes applicable to an individual company, and even for companies that determine executive compensation on a two or three year cycle.[20] Further, we have learned of instances where a company's compensation policies are established at the beginning of the year yet ISS issues its "say on pay" recommendations many months later, with no opportunity for the company to react or respond or understand the basis for the recommendation.

The impact on companies, investors and the market is significant. Fortunately, there is a straightforward solution: condition exemptive relief on the Firms' models and methodologies being subject to public disclosure. By so doing, the Commission would provide investors and the marketplace with a greater opportunity to evaluate Firm voting recommendations and their underlying rationale. Such action would also enhance the integrity and accuracy of Firm reports and promote accountability for Firm recommendations. Companies would have the opportunity to have a meaningful dialogue with their investors about why they believe the investors should support a management proposal that does not satisfy a Firm's model or methodology. All of this would serve to protect investors and the public interest. Moreover, this is a proven model that works well for other entities setting governance requirements for public companies, including NASDAQ itself and the other listing exchanges, which must publish their rules and any stated policy, practice or interpretations.[21] Commission action to improve transparency is imperative. It should act forthwith.

<u>Conflicts of Interest</u>

Another obvious flaw in the current system, and one noted in the Concept Release as a principal area of concern, are the undisclosed relationships that give rise to potential conflicts of interest in the midst of which proxy advisory firms operate and make money.[22] There are several variations of these conflicts.

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20 The inappropriateness of this one-size fits all approach was highlighted by former Commissioner Troy A. Paredes in a speech in which he advocated for action with respect to proxy advisory firms, noting in particular that the "… one-size-fits-all governance and pay practices [of proxy advisory firms] don't work so well for most companies. Proxy advisory firms should keep this in mind … given the understandable concern that has been raised that the recommendations of proxy advisory firms are too often based on a one-size-fits-all view of things. Indeed, given other concerns that have been expressed about proxy advisory firms — including that conflicts of interest may bias their recommendations and that their recommendations may be based on inaccurate information — it seems to me that the role of proxy advisory firms needs to be addressed." Commissioner Troy A. Paredes' remarks before the Society of Corporate Secretaries & Governance Professionals, 66th National Conference on "The Shape of Things to Come", July 13, 2012, available at: http://www.sec.gov/News/Speech/Detail/Speech/1365171490796.

21 *See* Section 19(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78s, and Rule 19b-4, 17 CFR 240.19b-4.

22 Concept Release at 116 et seq.

Glass Lewis has a built-in conflict of interest. It is a subsidiary of Ontario Teachers' Pension Plan Board ("OTPP") and Alberta Investment Management Corp. ("AIMCo"), which make investments in companies on which Glass Lewis makes recommendations. We understand that Glass Lewis has indicated that it will note in any research report on a company where OTPP or AIMCo have a significant stake in that company. However, it is not a stretch to imagine the conflicted loyalties, and the corresponding concerns over whether Glass Lewis is truly providing independent objective advice, when Glass Lewis' owners own the company on whose shareholder proposals Glass Lewis is opining, or a competitor. This concern is compounded by the fact that Glass Lewis does not share draft reports with companies.[23]

ISS' business model is inherently conflicted. At the same time it evaluates companies against its own non-transparent corporate governance guidelines, it profits as a consultant to help these same companies obtain higher ISS governance ratings and/or provide to institutional investor clients voting recommendations regarding these companies' shareholder proposals. In recent Congressional testimony, Former Commission Chairman Harvey Pitt made reference to these conflicts, noting that ISS, "when making recommendations on a shareholder proposal of competing slates of directors, do[es] not disclose if the proponent of the proposal or slate is a client."

The conflicting loyalties and possibly compromised advice engendered by these undisclosed and overlapping relationships does not serve companies or investors well. While ISS claims to have structural safeguards in place, as with Glass Lewis' built-in conflict, it is not hard to imagine the possibility that ISS' recommendations are influenced by the undisclosed relationships. And the failure to disclose these relationships is problematic for another reason: because companies and investors are not aware of them, a meaningful evaluation of ISS recommendations, including whether they are tainted or skewed by conflicts, is impossible. At a minimum, all such relationships should be disclosed so that companies and investors can evaluate the Firms' recommendations in the proper context and with complete information.

There is another troubling aspect to the multiple roles played by ISS. They create incentives for ISS to capitalize commercially on its vote recommendations, calling into question whether the recommendation is objective and in shareholders' best interest. For instance, the consulting arm of ISS may offer to sell a proprietary model to enable a company to determine whether a proposed equity plan would get a positive vote recommendation.[24] ISS may also offer consulting

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23 *See* letter from Tom Quaadman, Center for Capital Markets Competiveness, U.S. Chamber of Commerce, dated September 12, 2011, available at: http://www.sec.gov/comments/s7-14-10/s71410-301.pdf. *See, also*, Glass Lewis' Conflict of Interest Statement, available at: http://www.glasslewis.com/about-glass-lewis/disclosure-of-conflict/.

24 The Axcelis Letter offers a good example of this. After its recent shareholder meeting at which it was forced to modify a shareholder proposal to obtain a positive vote recommendation from ISS, a representative of ISS contacted Axcelis and indicated, according to Axcelis' letter, that "you have the ability to work with us prior to filing a proxy so you would know to a pretty high degree of certainty what the likely vote recommendation would be. … For any type of stock option proposal … you can model out different share requests before you actually reached the point of filing a proxy." *See, also,* tw telecom Letter (the failure to disclose decision models drives the demand for consulting business).

services to help a company improve its governance at the same time a different part of ISS issues corporate governance ratings on the same company. Indeed, as one commenter noted, "[i]t is clear that many issuers feel a subtle form of pressure to avail themselves of these services to decrease the risk of an adverse recommendation."[25]

Former Chairman Pitt publicly highlighted the perverse financial incentives that often lurk behind Firm recommendations. In his prepared testimony on behalf of the U.S. Chamber of Commerce before a subcommittee of the House Committee on Financial Services on June 5, 2013 in which he criticized ISS and Glass Lewis for recommending a "say on pay" vote every year, irrespective of a particular company's compensation practices, he noted that "[a]part from the utter waste and meaninglessness fostered by the ironclad ISS/Glass Lewis position on this issue, the one-year cycle they vigorously recommended, by definition, means that most, if not all, of the two firms' institutional portfolio manager clients will need to retain ISS and Glass Lewis to fulfill their obligation to vote yearly on executive compensation."[26]

Notably, the Commission addressed transparency and conflict of interest concerns similar to those discussed herein in the context of credit rating agencies. This is relevant to the present case because the similarities between proxy advisory firms and rating agencies are significant, namely, both use proprietary models, both make recommendations that are widely relied on by investors and others, and both have been subject to criticism over concerns of data integrity and conflicts of interest.[27] In the case of credit rating agencies, as required by Dodd Frank, the Commission proposed rules governing the disclosure of conflicts of interest and credit rating methodologies.[28] The Commission should condition its exemptive relief on the recipients adopting this same model.

Conclusion

The Firms, despite extensive conflicts, have been empowered by government action and institutional practice to be the primary and unsupervised arbiters of governance practices in the United States. These circumstances should cause grave concern because the Firms are accountable to no one, engaged in opaque but important rule setting, have no incentive to act in the public interest, and are incentivized to make the system as complex and expensive as possible. Fortunately, there is a solution, which the Commission has the authority to quickly and easily implement. And that is, require public scrutiny of the models and methodologies on which the Firms rely to make recommendations and mandate disclosure of all potential conflicts of interest.

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25 *See* tw telecom Letter.

26 Pitt Testimony available at: http://financialservices.house.gov/uploadedfiles/hhrg-113-ba16-wstate-hpitt-20130605.pdf

27 *See* Western Digital Letter.

28 http://www.sec.gov/spotlight/dodd-frank/creditratingagencies.shtml

Such action would ensure that Firm voting policies, and their underlying rationales, are developed and implemented in a transparent and meaningful manner, in the best interests of companies and their shareholders. Such action is also necessary to ensure that proxy firm reports and recommendations are factually accurate and tailored to reflect the individual condition and structure of each company. Finally, such action is necessary to ensure that all conflicts of interest that may influence or otherwise compromise the integrity of recommendations are disclosed, thereby allowing companies and their shareholders to evaluate the vote recommendations with complete information.

By this Petition, NASDAQ urges prompt action by the Commission to address the lack of transparency and conflicts inherent in the U.S. proxy advisory firm model.

If you have any questions, or if we can provide any additional information that would be helpful to the Commission or its staff, please feel free to call me.

Sincerely,

Edward S. Knight

cc: Chairman Mary Jo White
Commissioner Luis A. Aguilar
Commissioner Daniel M. Gallagher
Commissioner Kara M. Stein
Commissioner Michael S. Piwowar
Norm Champ, Director, Division of Investment Management
Keith F. Higgins, Director, Division of Corporation Finance
John Ramsay, Acting Director, Division of Trading and Markets
Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management