

# GovernanceMetrics International

November 16, 2005

Mr. Jonathan G. Katz  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington, DC 20549-9303

## **RE: Client Commission Practices under Section 28(e) (File No. S7-09-05)**

Dear Secretary Katz:

Thank you for the opportunity to comment on the SEC's interpretive release concerning soft dollar payments.

GovernanceMetrics International (GMI) is an independent corporate governance research and ratings company. We offer clients a choice of paying for our annual subscription services in either hard or soft dollars. If clients opt to pay in soft dollars we do not direct which broker they work with. They make their own determination based on best execution for client trades. While most of our clients chose to pay in hard dollars we believe the soft dollar option available Section 28(e) of the '34 Act allows our clients greater flexibility and adds to market efficiencies in that it offers certain institutional investors a means of accessing independent research that might not otherwise be available to security analysts and portfolio managers.

Question 7 of the Interpretive Release asks whether additional guidance would be useful for certain types of products or services that are commonly paid for with client commissions, including proxy voting services. We believe the answer is yes and would recommend the Commission specifically address the eligibility of corporate governance research and rating services under the safe harbor of Section 28(e).

### **About GMI**

GMI is employed by a wide variety of financial institutions throughout North America, Europe and the Asia-Pacific region to assess the governance characteristics of public companies to identify those with progressive practices and those with heightened risk stemming from weak governance. Our clients include pension funds, fund managers, banks, insurers, issuer companies, advisory firms and regulatory agencies, including the Public Company Accounting Oversight Board (PCAOB).

GMI does not offer proxy voting services. Corporate governance research and rating services like ours are somewhat related but are a relatively new type of service offering. While our business concept pre-dates Enron, you would not be surprised to know that the application of corporate governance into the investment decision making process (as well

# GovernanceMetrics International

as commercial lending and insurance underwriting) has taken on greater significance as a direct result of the corporate scandals of the last few years.

Our firm provides research and ratings only and does not offer consulting services to rated companies. At GMI, the focus is on consistency and impartiality. Our analysts apply pre-specified criteria to research and answer each metric in our system. GMI rating criteria are based on an appraisal of best practices in corporate governance, including statistical analysis, empirical research, stock exchange listing requirements and model corporate governance codes like the Organisation for Economic Cooperation and Development (OECD). In addition, the criteria incorporate the views of GMI's corporate governance and legal advisors as well as input from institutional investors, corporate officers and company directors and are revised on an annual basis.

GMI starts the rating process by developing a highly-detailed governance profile incorporating hundreds of data points per company. In addition to reviewing board composition, board leadership, company documents and websites to identify stated policies and procedures, GMI also reviews regulatory actions, legal proceedings and other sources to gauge whether company behavior is consistent with its stated policies.

Once database profiles are complete, GMI applies an asymmetric geometric scoring algorithm to generate company ratings on a scale of 1.0 to 10.0 (10.0 being the highest). The use of asymmetric geometric scoring is meant to magnify the impact of outliers. This includes both those with the very best practices or those with the worst. GMI scores are relative in that each company is scored against other companies in the GMI research universe.

Companies are assigned 14 ratings in all. One set of ratings (seven in total) compares each company to a global universe. Within this universe, companies receive an overall GMI rating and a separate rating for each category of analysis:

- board accountability
- financial disclosure and internal controls
- shareholder rights
- executive compensation
- takeover defenses and ownership base
- corporate accountability (includes matters like management of environmental risks, labor relations, foreign-sourcing practices, litigation and regulatory actions)

In the second set of ratings, companies receive another overall rating and six section ratings, but this time the ratings are relative to others in the same country of domicile. This way, subscribers can see how companies compare within their home market but can also benchmark globally.

Each company's Rating Report includes a summary of the company's overall governance profile and commentary on each of the research categories. GMI also profiles each member of the board of directors and provides a "red flag" service to alert subscribers

# GovernanceMetrics International

about governance issues such as the dilutive impact of stock option plans that have the potential to affect shareholder value. In addition, subscribers are able to filter the GMI website to view company ratings only within specific industries, within selected geographic regions, or by market cap.

GMI systematically re-rates all companies in its system every three months. In-between these scheduled ratings GMI monitors each company in its research universe on a daily basis and posts news Updates as events warrant. GMI will also generate new ratings in between our scheduled ratings for significant changes in rated company profiles. Subscribers are notified of key mid-cycle developments by means of e-Alerts and receive GMI rating data files in Excel, CSV or XML format for screening or benchmarking purposes. All of our services are delivered electronically over the GMI website, via FTP or by e-mail. Clients can also access certain GMI ratings data over Bloomberg and FactSet.

All companies rated by GMI are given a chance to review the data GMI has collected on their governance practices prior to GMI calculating their ratings. There is no charge for this review - it is designed solely as a quality control measure. As long as the company has disclosed relevant information in the public domain, GMI will credit the company in its metrics. Companies are rated by GMI based on their inclusion in a market-based index. There is no cost to the company for a rating.

## **How Are GMI Services Used?**

GMI Ratings, Rating Reports, Updates and e-Alerts are designed to complement traditional security analysis. GMI customers use our services in a number of different ways, depending on their investing style:

- as part of overall investment strategy for fundamental analysts
- as a screening tool for quantitative analysts and portfolio managers
- to adjust for governance risk in capital asset pricing models
- to adjust for governance risk in credit risk models
- as a complement to quality of earnings analysis
- to prepare for analyst calls or meetings with portfolio companies
- to augment proxy voting decisions in contested elections and other high profile votes

We believe each of these applications fall within the safe harbor of Section 28(e).

## **Research Studies**

Market interest in corporate governance research and analysis is based in part on the sheer number of recent debacles showing that bad governance can be very costly. But there is also a growing body of literature suggesting a link between corporate governance, corporate performance and cost of capital over the long-term. Below are some of significant research studies of the last few years culled from GMI's own research

# GovernanceMetrics International

bibliography, which includes more than 200 papers examining the relationship between governance, performance and cost of capital.

Ira Millstein is senior partner at the New York law firm Weil, Gotshal & Manges and a well-known and respected corporate governance expert. Paul MacAvoy is the Williams Brothers Professor of Management at the Yale School of Management. The authors' hypothesis is that a professional board, which is independent of management, should tip the scales in favor of higher returns to investors. Their empirical study of 154 firms based on 1991-1995 data found that the added returns to investors associated with the presence of a professional board were positive and significant as measured by earnings in excess of cost of capital over the industry average.<sup>1</sup>

In a landmark paper, Paul A. Gompers, professor of business administration at Harvard, Wharton finance professor Andrew Metrick and Joy L. Ishii of the Harvard Economics Department found that corporate governance was strongly correlated with stock returns during the 1990s.<sup>2</sup> Gompers and his colleagues rated 1,500 companies for each year of the '90s on a "Governance Index" which gave equal weight - one point, or "G" - to each of 24 shareholder-rights provisions. The firms were ranked by decile: the 10 percent of firms with the most anti-shareholder provisions were in the highest decile of the index, comprising the "Management Portfolio." Those with the least provisions were in the lowest decile, the "Shareholder Portfolio." An investment strategy that purchased shares in the lowest-G firms ("Democracy" firms with strong shareholder rights), and sold shares in the highest-G firms ("Dictatorship" firms with weak shareholder rights), earned abnormal returns of 8.5 percent per year. At the beginning of the sample, there was already a significant relationship between valuation and governance: each one-point increase in G was associated with a decrease in Tobin's Q of 2.2 percentage points. By the end of the decade, this difference had increased significantly, with a one-point increase in G associated with a decrease in Tobin's Q of 11.4 percentage points. The results for both stock returns and firm value were economically large and were robust to many controls and other firm characteristics.

GMI's in-house research also found a substantive connection between good governance practices and performance as measured by average annual total returns to shareholders. In the short-term (1 year), the link between the two was not considered significant, but looking at the longer-term (3, 5, and 10 years), there appears to be a connection between good governance practices and performance.<sup>3</sup> Further, a study conducted jointly by

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<sup>1</sup> Millstein, Ira M. and Paul W. MacAvoy. June 1998. The Active Board of Directors and Performance of the Large Publicly Traded Corporation. *Columbia Law Review*, 98. 1283-1322.

<sup>2</sup> Gompers, Paul A., Joy L. Ishii and Andrew Metrick. February 2003. Corporate Governance and Equity Prices. *Quarterly Journal of Economics*, Vol. 118, No. 1, 107-155.

<sup>3</sup> GovernanceMetrics International. GMI Governance and Performance Analysis, September 2003 and March 2004.

# GovernanceMetrics International

Lipper Inc. and GMI found that mutual funds holding a greater preponderance of well governed companies outperformed and had less risk than others.<sup>4</sup> The two firms paired the stock holdings of 725 large-cap domestic equity mutual fund portfolios in Lipper's database with the governance ratings calculated by GMI for more than 1000 publicly traded firms. Lipper and GMI looked at each fund's allocation to stocks with high (favorable) governance ratings and those with lower governance ratings. For all three of the standard large cap fund styles (value, core and growth) the funds with large holdings of poorly governed firms had lower total returns and poorer risk ratings than those funds that invested in better governed stocks.

Another paper of note provides evidence linking corporate governance mechanisms to higher bond ratings and lower bond yields.<sup>5</sup> The authors hypothesized that governance mechanisms can reduce default risk by mitigating agency costs and monitoring managerial performance and by reducing information asymmetry between the firm and the lenders. The authors found firms that have greater institutional ownership and stronger outside control of the board enjoyed lower bond yields and higher ratings on their new bond issues. These results were robust to a specification that controls for institutional ownership being influenced by bond yields.

## Market Developments

In addition to investor applications and research studies, we also wanted to bring to your attention some related market developments that speak to the growing application of corporate governance in the research process. These are the Investment Protection Principles, Enhanced Analytics Initiative, changes in manager assessments by Mercer Investment Consulting, and the Freshfields Bruckhaus Deringer / UNEP FI Asset Management Working Group Study.

**Investment Protection Principles:** “As public institutional investors responsible for the safekeeping of taxpayer and retirement funds belonging to millions of Americans, we cannot tolerate the deception and lack of integrity that have shaken confidence in our financial markets. As representatives of over \$1 trillion combined in institutional capital, we have an obligation and an opportunity to exercise the power of the purse to achieve meaningful reforms that will do all of the following: restore investor confidence in the markets; protect the public from unprecedented losses due to corporate malfeasance; and promote real long-term value in companies and growth in our economy.”

“Therefore, today we commit to use our power in the marketplace to bring about strong and meaningful reforms. We will mobilize our consumer power as never before to demand integrity among corporate executives and boards of directors, deter unscrupulous

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<sup>4</sup> GovernanceMetrics International and Lipper, January 2004. Corporate Governance as a Factor in Mutual Fund Holdings.

<sup>5</sup> Bhojraj, Sanjeev & Partha Sengupta, 2003. Effect of Corporate Governance on Bond Ratings and Yields: The Role of Institutional Investors and Outside Directors. The Journal of Business, Vol 76, No.3.

# GovernanceMetrics International

business practices, strengthen accountability to investors and shareholders, and bring about a renewed faith in the financial marketplace. Effective July 1, 2002, every money management firm retained by the State Treasurer of North Carolina, the Comptroller of the State of New York, or the State Treasurer of California, as a condition of future retention, must abide by the following: (6) In deciding whether to invest State or Pension Fund moneys in a company, money management firms must consider the corporate governance policies and practices of the subject company.”<sup>6</sup>

**Enhanced Analytics Initiative:** “Today sees the launch of an initiative by institutional investors to address one of the obstacles to investors taking a longer-term and more rounded assessment of corporate performance – namely the current focus of much sell-side research. The founding members of this initiative, all major fund managers and significant clients in their individual right, have agreed to allocate 5% of their broker commissions on the basis of how well brokers integrate analysis of extra-financial issues and intangibles. Such issues typically include corporate governance, human capital management, value creation or destruction during mergers and acquisitions, or global environmental challenges such as climate change.”

The founding members are BNP Paribas Asset Management, PGGM, RCM, Deutscher Investment Trust, Dresdner Bank Investment Management and the Universities Superannuation Scheme (USS).

According to Peter Moon, CIO, USS Ltd: “We decided to help launch this project because both we and our brokers know the current approach is producing a lot of research which adds little value. Extra-financials and intangibles can account for a significant proportion of the value of a company, especially over the longer term. We feel that a catalyst is required to encourage active participation by broking houses, therefore allocating 5% of the research budget seems a pragmatic incentive to enable brokers to produce more rounded, more useful research.”

Neil Dwane, CIO Europe of RCM said: “Many clients are, rightly, looking for fund managers to better manage long term risks and opportunities, and to better manage absolute risks and deliver greater alpha. Traditional investment analysis is very well suited to short term investment but if you are trying to take a longer term view, the most informative notes are those that take the material extra-financial aspects of corporate performance into account. We therefore view the allocation of commissions as a fundamental part of our fiduciary duty to protect and manage our client assets and part of that duty is to represent their requirements for good and consistent governance.”<sup>7</sup>

**Mercer Investment Consulting:** Mercer Investment Consulting (Mercer IC) recently extended its research of investment managers to systematically evaluate their performance with regard to “active ownership” practices (including proxy voting and

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<sup>6</sup> State and Public Pension Fund Investment Protection Principles, August 12, 2002

<sup>7</sup> Enhanced Analytics Initiative, News Release, October 18, 2004

# GovernanceMetrics International

shareholder engagement) and the incorporation of environmental, social, and corporate governance (ESG) analysis into mainstream decision making. Two developments led Mercer IC to undertake this new research. First, institutional asset owners are increasingly behaving as active owners of capital. Second, a growing number of investors believe that ESG issues can have an impact on the earnings of portfolio companies and, therefore, on investment performance, and so should be integrated into investment analysis, according to Mercer IC.

“In the past, it was just a small group of organizations that were interested in active ownership and ESG analysis. But there are a growing number of mainstream investors who believe these issues can have an impact on long-term investment performance,” said Tim Gardener, global leader of Mercer IC. Using its proprietary methodology, Mercer IC initially analyzed 30 investment managers rated highly for their UK and/or global equity products. These managers have responsibility for assets in excess of US\$12 trillion and cover a wide spectrum of firms, from small regional boutique equity specialists managing US\$134 million to larger national firms managing over a trillion in assets. Managers were scored according to their capacity and capabilities in three new areas: voting and engagement on corporate governance issues; voting and engagement on environmental and social issues; and integration of ESG issues into investment decision making processes. Mercer IC said research into additional managers is already underway.<sup>8</sup>

**Freshfields Paper:** “Institutional investors have a far greater opportunity - and in some cases a legal obligation - to incorporate environmental, social and governance issues into their investment decision-making than is traditionally believed” concludes a new study, done on behalf of the United Nations Environment Programme’s Finance Initiative. “The study finds that the integration of environmental, social and governance (ESG) issues into investment analysis, so as to more reliably predict financial performance, is clearly permissible and is arguably required in all jurisdictions.”

The study, launched at the United Nations, was compiled by leading international law firm Freshfields Bruckhaus Deringer. The 150-page report, which focuses on the largest capital markets jurisdictions - Australia, Canada, France, Germany, Italy, Japan, Spain, the UK and the US, also considers the likely evolution of the interpretation of the law with respect to investors and ESG issues.

Klaus Toepfer, Executive Director of UNEP, commenting on the study, said: "This is groundbreaking work that will accelerate the integration of ESG issues into the mainstream investment community worldwide. What was once considered a niche area is set to become mainstream as institutions with trillions of dollars under management embed ESG thinking into their investment approach." He added: "As the world's largest pension schemes, government funds, insurance reserves and foundations adjust this will set in train a new dynamic along the investment chain. When these large institutional investors move on ESG issues the broader markets will listen and react."

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<sup>8</sup> Mercer Investment Consulting, News Release, October 17, 2005

# GovernanceMetrics International

Paul Watchman, Partner at Freshfields Bruckhaus Deringer and senior author of the study, told more than 450 participants at the two-day UNEP FI 2005 Global Roundtable meeting at UNHQ that: "We are not suggesting that investors pursue a moral crusade but, in most jurisdictions, the law gives a wide discretion, encircled by general duties rather than exacting standards. A number of the perceived limitations on investment decision-making are illusory.

Mr. Watchman explained that those advocating a greater regard for ESG issues in investment decision-making often encounter resistance on the basis of a belief that institutional principals and their agents are legally prevented from taking account of such issues. "Far from preventing the integration of ESG considerations, the law clearly permits and, in certain circumstances, requires that this be done," he said.

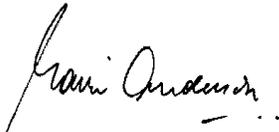
The report's lead author concluded by stressing that: "Institutional investors have more freedom to integrate ESG issues into their decision-making than they think. Whilst normally we find ourselves encouraging our clients to be more cautious, in this case we can instead say 'be more imaginative'."<sup>9</sup>

## Conclusion

In closing, thank you again for the opportunity to offer our comments on this important issue. We hope this letter has provided some useful information and hope the Commission understands why we think the current interpretive release presents a timely opportunity to address the specific eligibility of corporate governance research and rating services under the safe harbor of Section 28(e).

Please do not hesitate to contact me at 212-949-1313 if we can be of further assistance.

Sincerely yours,



Gavin Anderson  
President and CEO

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<sup>9</sup> United Nations Environment Programme, News Release, October 25, 2005. See also Freshfields Bruckhaus Deringer, "A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment." Produced for the Asset Management Working Group of the UNEP Finance Initiative, October 2005.