



INSTITUTIONAL SHAREHOLDER SERVICES

December 5, 2005

Via Electronic Mail to Rule-Comments@sec.gov

Jonathan G. Katz, Secretary
U.S. Securities and Exchange Commission
100 F. Street, N.E.
Washington, D.C. 20549

Re: *Commission Guidance Regarding Client Commission Practices under Section 28(e) of the Securities Exchange Act of 1934, File No. S7-09-05*

Dear Mr. Katz:

Institutional Shareholder Services Inc. ("ISS") is pleased to submit these comments on the Commission's proposed interpretive guidance regarding permissible client commission practices under Section 28(e) of the Securities Exchange Act of 1934.¹ We commend the Commission for its thoughtful efforts to clarify the types of products and services that may qualify as "brokerage and research" under this provision. While we generally endorse the proposed interpretation, we respectfully ask the Commission to confirm in its final guidance that certain proxy services may be covered by the Section 28(e) safe harbor.

With twenty years of experience and more than 1,600 institutional clients around the globe, ISS is the world's leading provider of proxy voting and corporate governance services. Our core business assists institutional investors with all aspects of proxy voting, from the analysis of proxy proposals and the formulation of voting decisions through the mechanics of casting proxy votes, vote disclosure and recordkeeping.² Our suite of institutional products and

¹ See SEC Release No. 34-52635 (October 19, 2005), 70 Fed. Reg. 61700 (October 25, 2005) ("Proposing Release").

² We also offer a comprehensive database of securities class actions and services to assist institutional investors in participating in applicable class action settlements. Completely separate from our institutional business, ISS also serves the corporate market with a variety of governance web-based tools and other services that assist issuers with identifying and complying with corporate governance best practices. A complete listing of our products and services is available at www.issproxy.com.

services can be roughly categorized into three groups: proxy research, database analytics, and voting services.

On the proxy research side, ISS analyzes shareholder proposals and produces informed analyses and objective vote recommendations for more than 33,000 companies across 115 markets worldwide. ISS measures the impact of proxy issues on shareholder value for complex matters such as executive and director compensation, options expensing, mergers and acquisitions and contested solicitations. Our analyses and recommendations may be based on ISS' standard policy guidelines or on clients' customized guidelines. We also produce specialized analyses and vote recommendations for managers of Taft-Hartley funds and managers following socially responsible investment strategies.

ISS' database analytics include tools that assist institutional investors in evaluating the quality of corporate boards and the impact their governance practices may have on performance. Other tools can be used to monitor and analyze proxy voting policies, voting trends and policy outliers and to compare one manager's voting record on ballot issues to that of a peer group.

Our voting services allow institutional investors to outsource the mechanics of proxy voting or to cast their own votes electronically through our web-based proxy voting platform. These services also help registered investment advisers and mutual funds meet their proxy vote disclosure and recordkeeping obligations under the Investment Advisers Act of 1940 ("Advisers Act") and the Investment Company Act of 1940 ("Company Act").³

It is our experience that money managers frequently use client commissions to pay for proxy analyses and vote recommendations, but not for services related to the mechanics of proxy voting, vote disclosure or recordkeeping. Where a manager subscribes to a combination of proxy services, the cost is typically split between hard and soft dollars so that client commissions are used for the analyses and recommendations and cash is paid for the more administrative services.⁴

We understand that these current payment practices would generally be permitted under the Commission's proposed new interpretation of Section 28(e). In order to provide meaningful

³ See, e.g., Advisers Act Rules 206(4)-6 and 204-2(c)(2), and Company Act Rule 30b1-4.

⁴ We note that our observations of commission payment practices relating to proxy services seem to be consistent with the findings of the SEC's Office of Compliance Inspections and Examination in its 1998 soft-dollar sweep report. *Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds* (Sept. 22, 1998), available at <http://www.sec.gov/news/studies/softdolr.htm>. In Appendix D to this Report, proxy services are listed in the "Research," "Mixed-Use" and "Non-Research" categories.

guidance in this area, we respectfully request that the Commission confirm this understanding in its final interpretive release.

***Proxy Services And The Proposed New
Interpretation of "Research" Under Section 28(e)***

Relying on the legislative history of Section 28(e) and the statutory language itself, the Commission proposes a three-step approach for analyzing whether a particular product or service falls within the safe harbor. The first step of this process entails determining whether the product or service is "eligible" under the safe harbor; where research is involved, this means determining whether the product or service is specifically described in Section 28(e)(3)(A) or (B). These provisions cover written or oral advice regarding the value of securities, the advisability of investing in, purchasing or selling securities and the availability of securities or purchasers or sellers of securities, as well as analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, the performance of accounts and other topics related to securities and the financial markets.⁵ According to the Commission, in order to qualify as "advice," "analysis" or a "report," a product or service must reflect the expression of reasoning or knowledge that relates to one of the subject areas identified in the statute.

The second step involved in analyzing the availability of the safe harbor is determining whether the eligible product or service actually provides lawful and appropriate assistance to the money manager in the performance of his investment decision-making responsibilities. And the third step is a good-faith determination that the amount of client commissions paid is reasonable in light of the value of the products or services that the broker-dealer is providing to the money manager.

As a general matter, ISS believes that this analytical framework is clear and sensible. We also believe that, judged by the proposed new standard, proxy services qualify for the safe harbor under appropriate circumstances. In particular, the analyses of proxy proposals and vote recommendations constitute "analyses and reports concerning issuers, . . . securities" and related topics. To the extent that a proxy proposal deals with a merger, acquisition or divestiture, or some other issue that affects shareholder value, these products and services could also be construed as "advice regarding the value of securities [or] the advisability of investing in, purchasing or selling securities." In each case, the proxy analyses and vote recommendations reflect the expression of reasoning or knowledge of the proxy analyst.

⁵ In explaining its new guidance, the Commission noted that "the categories expressly listed in Section 28(e)(3)(A) and (B) also 'subsume' other topics related to securities and the financial markets." Proposing Release at 27, 70 Fed. Reg. at 61706 (citation omitted).

In addition to satisfying the eligibility criteria, proxy analyses and vote recommendations also meet the "lawful and appropriate assistance" test where the money manager uses these products and services to make buy/sell/hold decisions or to satisfy his fiduciary duty to vote proxies on clients' behalf. As the regulators have long recognized, proxy voting is an integral part of a manager's investment decision-making responsibilities.

In adopting the proxy disclosure rule under the Advisers Act, the Commission noted that where an adviser is authorized to vote proxies, she has a fiduciary duty to monitor corporate events and to vote proxies in a manner consistent with the best interests of her clients.⁶ The Commission also advised that voting authority need not be explicit, but rather can be implied from an overall delegation of discretionary authority over a client's account.⁷ Finally, the Commission recognized that through their proxy voting authority, investment advisers are "in a position to significantly affect the future of corporations, and, as a result, the future value of corporate securities held by their clients."⁸ The link between proxy voting and investment decision-making has been articulated by the U.S. Department of Labor ("DOL") in the pension plan context as well. In a 2001 interpretive bulletin, DOL opined: "The fiduciary act of managing plan assets that are shares of corporate stock includes the voting of proxies appurtenant to those shares of stock."⁹

Because of the connection between proxy voting and a manager's investment decision-making responsibilities, it appears that so long as the manager satisfies the reasonableness-of-commissions test, an arrangement whereby client commissions are used to acquire proxy analyses and vote recommendations should be covered by Section 28(e).

⁶ IA Rel. No. 2106 at 2-3 (January 31, 2003), 68 Fed. Reg. 6585, 6586 (February 7, 2003).

⁷ *Id.* at 4, 68 Fed. Reg. at 6587.

⁸ *Id.* at 2, 68 Fed. Reg. at 6586. The Commission made a similar observation in adopting the proxy disclosure requirements under the Company Act. SEC Rel. No. IC-25922 (January 31, 2003) at 4, 68 Fed. Reg. 6564, 6566 (February 7, 2003) ("Proxy voting decisions by funds can play an important role in maximizing the value of the funds' investments, thereby having an enormous impact on the financial livelihood of millions of Americans").

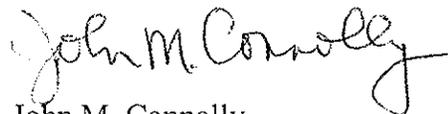
⁹ DOL Interpretive Bulletin Relating to Written Statements of Investment Policy, Including Proxy Voting Policy or Guidelines, 29 CFR 2509.94-2. See also "Proxy Project Report, Pension and Welfare Benefits Administration ("PWBA"), DOL (March 2, 1989) at 8 ("The normal course of management of plan assets which are corporate stock includes decisions with respect to voting proxies connected to those shares of stock"); letter from Alan D. Lebowitz, Deputy Assistant Secretary, PWBA to unnamed plan fiduciary (Feb 23, 1988) (the decision as to how proxies should be voted is a fiduciary act of plan asset management).

Applying the proposed interpretive guidance to proxy and corporate governance database analytics indicates that these products and services also could fit within the safe harbor, depending on how they are used. As for the first prong of the framework, it appears that the analytic tools would be considered eligible products and services, since they reflect the expression of reasoning or knowledge relating to the subject areas identified in Section 28(e)(3)(A) and (B).¹⁰ Where these tools are used to evaluate corporate governance practices for the purpose of selecting investments or determining how to vote proxies, the second test of Section 28(e) coverage would appear to be satisfied as well. However, a manager's use of the tools to assess the manager's compliance with his proxy voting guidelines, to prepare client reports or for other administrative purposes would seem to fall outside the safe harbor. If the tools are used for both purposes -- which is likely -- they would be considered "mixed-use" items, as to which a cost allocation between cash and client commissions would be required.

Finally, under the proposed interpretation, those proxy services that assist money managers with the mechanics of casting proxy votes, recordkeeping and vote disclosure would fall outside the safe harbor, as they do today.

ISS believes that it would be enormously helpful to the industry if the Commission were to confirm the status of proxy services under the new interpretation of Section 28(e). We very much appreciate the opportunity to express our views on this issue. If you have any questions in this area, please call Steven E. Friedman, ISS' Chief Legal Officer and Chief Compliance Officer at 301-556-0420.

Very truly yours,



John M. Connolly
President and CEO

Cc: The Honorable Christopher Cox
The Honorable Paul S. Atkins
The Honorable Roel C. Campos
The Honorable Cynthia A. Glassman
The Honorable Annette L. Nazareth
Mr. Robert L.D. Colby
Mr. Larry E. Bergmann
Mr. Meyer Eisenberg
Mr. Robert E. Plaze

¹⁰ See Proposing Release at 28, 70 Fed. Reg. at 61707.