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DISCUSSION DRAFT
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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

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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.

imposing fiduciary obligations to vote proxies for stocks owned by ERISA retirement and pension plans.[3]

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:

[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.

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.

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[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.

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

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.

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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

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.

- 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

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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.

[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.

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 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]

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[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.").

[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.

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.

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

[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.").

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.