Center On Executive Compensation

October 25, 2010

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

RE: Comments on Concept Release on the U.S. Proxy System
File Number S7-14-10

Dear Ms. Murphy:

The Center On Executive Compensation is pleased to submit comments to the Securities and Exchange Commission ("Commission") providing its perspective on the Commission's concept release on the U.S. Proxy System. Our comments focus on our concerns that the increasing influence of proxy advisory firms over institutional investor votes on executive compensation and related governance matters is insufficiently regulated. The existing regulatory structure allows institutional investors to discharge their proxy voting duties by relying on proxy advisory firm recommendations. Combined with the lack of oversight, the current regulatory structure permits alarming conflicts of interest to influence proxy voting and material inaccuracies in reports produced by the firms to proliferate.

The Center On Executive Compensation is a research and advocacy organization that seeks to provide a principles-based approach to executive compensation policy from the perspective of the senior human resource officers of leading companies. The Center is a division of HR Policy Association, which represents the chief human resource officers of over 300 large companies, and the Center's more than 70 Subscribing Companies are HR Policy members that represent a broad cross-section of industries. Because senior human resource officers play a unique role in supporting the compensation committee chair, we believe our views can be particularly helpful in understanding the important role that carefully constructed executive compensation packages play in ensuring a strong link between pay and performance.

I. Executive Summary

This comment letter focuses on the issues raised in the concept release on the U.S. Proxy System related to proxy advisory firms, which play an increasingly influential role in corporate governance and in determining how institutional investors vote on corporate proxy issues. This letter addresses six substantive areas addressed by the questions about proxy advisors contained in the concept release:

- The degree of influence proxy advisors have over corporate governance and proxy voting;
- The need to prohibit the most egregious conflict of interest in the proxy advisory industry and require more complete disclosure of others;

- The recognition that material inaccuracies in data and information provided by proxy advisory firms appear to be increasing, with significant potential effects on proxy voting;
- The lack of a competitive market structure in the industry and its impact on proxy voting positions and quality control;
- The behavior of issuers toward proxy advisors; and
- How proxy advisory firms should be regulated.

The Center believes that proxy advisory firms play an important role that can help institutional investors fulfill their fiduciary duty to vote their proxies in their clients' best interest. However, without a more rigorous federal regulatory and oversight process, we are concerned that integrity of the proxy system may be undermined by growing evidence of material inaccuracies and conflicts of interest by the proxy advisors. Our detailed comments on these issues follow.

III. Proxy Advisors Have Considerable Influence Over Institutional Shareholder Votes

The empirical data in academic studies strongly suggests that the recommendations of proxy advisory firms play a significant role in how institutional investors vote. These studies conclude that proxy advisor recommendations have the power to swing from 6% to 20% of the votes cast in corporate elections or on shareholder ballot proposals.[1] One study noted that ISS's vote recommendations in contested director elections "are good statistical predictors of outcomes," in part because they influence investors to revise their assessment of board nominees.[2] The influence is notable because different institutional investors use the voting recommendations provided by proxy advisory firms in several different ways in making a voting decision. Some use the recommendations as one input among many while others voting in strict accordance with them. Yet, regardless of how they are used, the recommendations have significant impact on the voting outcome.[3]

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[1] Academic studies addressing the influence of proxy advisor voting recommendations include:
- Jennifer E. Bethel and Stuart L. Gillan, "The Impact of the Institutional and Regulatory Environment on Shareholder Voting," *Financial Management*, Vol. 31, No. 4 (Winter 2002).
- Ernst G. Maug and Kristian Rydqvist, "Do Shareholders Vote Strategically?," European Corporate Governance Institute, Working Paper, 2006.
- Stephen Choi, Jill Fisch and Marcel Kahan, "Director Elections and the Influence of Proxy Advisors," NYU Law and Economics Research Paper Series, Working Paper 08-22, May 2008.
- Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt, "The Role of Advisory Services in Proxy Voting," National Bureau of Economic Research, Working Paper No. 15143, July 2009.

[2] Cindy R. Alexander, Mark A. Chen, Duane J. Seppi, and Chester S. Spatt, "The Role of Advisory Services in Proxy Voting," National Bureau of Economic Research, Working Paper No. 15143, July 2009.

[3] The proxy solicitation firm Innisfree M&A, for instance, found that ISS clients typically control 20 to 30 percent of a mid-cap or large-cap company's outstanding shares, while Glass Lewis clients typically control 5 to 10 percent. Yin Wilczek, "Bounty Program to Cramp Corporate Boards: ABA Speakers Discuss Governance Provisions," Daily Report for Executives, Aug. 10, 2010.

Because proxy advisory firms have enormous power to influence corporate governance through their direct impact on institutional voting, the proxy advisory firms also have tremendous impact on decisions made by corporate boards and managers. There is strong evidence that many firms are modifying their compensation programs primarily to obtain favorable recommendations from proxy advisory firms. For instance, a recent survey of Chief Human Resource Officers conducted by the HR Policy Association found that in the last three years, 54% of respondents had changed or adopted a compensation plan, policy or practice primarily to meet the standards of a proxy advisory firm and changes include the structure of stock plans, parameters of incentive plans and disclosure.

A primary reason for institutional investor reliance on proxy advisory firms is a 2003 SEC interpretation that indicated that investment advisors could discharge their duty to vote their proxies and demonstrate that their vote was not a product of a conflict of interest if the vote was made in accordance with a pre-determined policy and based on the recommendations of an independent third party.[4] The advisory firms are considered independent third parties, and if institutional investors rely on the recommendations made by them, the investors are held to have discharged their fiduciary duties to vote in the investors' best interests. Reflecting this point, the Honorable Leo E. Strine, Jr., Vice Chancellor of the Delaware Court of Chancery, commented that "the influence of ISS and its competitors over institutional investors' voting behavior is so considerable that traditionalists will be concerned that any initiative to increase stockholder power will simply shift more clout to firms of this kind."[5] As discussed below, the conflicts of interest inherent in the models of most advisory firms call their independence into question.

Ideally, institutional investors, consistent with their fiduciary obligation to vote their proxies, would be more involved in ensuring that the recommendations made by proxy advisors and the votes that are based on those recommendations are consistent with the creation of long-term shareholder value. As a consequence of many institutions having a very large number of security holdings, however, coupled with the ever-larger volume of material that issuers are required to disclose in proxy statements, it is perhaps somewhat naïve to expect that investors will rely less heavily on outsourcing proxy analysis to advisors to meet their proxy research and voting needs. At a minimum, the fiduciary requirements of institutional investors to assess and monitor conflicts of interest at their proxy advisors, and to assess the quality and accuracy of the research and vote recommendations they are receiving from those advisors, should be vigorously enforced by the Commission.

IV. Address Conflicts of Interest Through Prohibition and Disclosure

It is widely acknowledged that there are serious conflict of interest issues in the proxy advisory industry. These issues appear most acute at the dominant firm in the industry, ISS Governance Services, a Division of MSCI, Inc., which provides services to both institutional

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[4] *See* Securities and Exchange Commission, Proxy Voting by Investment Advisers, Release No. IA-2106, Jan. 31, 2003 (17 CFR Part 275) ("[A]n adviser could demonstrate that the vote was not a product of a conflict of interest if it voted client securities, in accordance with a pre-determined policy, based upon the recommendations of an independent third party. An adviser could also suggest that the client engage another party to determine how the proxies should be voted, which would relieve the adviser of the responsibility to vote the proxies.")

[5] Leo E. Strine, Jr., "Towards a True Corporate Republic: A Traditionalist Response to Lucian's Solution for Improving Corporate America," Olin Center for Law, Economics and Business, Harvard University, Discussion Paper No. 541, Feb. 2006.

investors and to corporate issuers. However, there are also concerns about whether the ownership structures and business relationships of proxy advisory firms compromise their independence. Concerns about conflicts of interest in the industry fall into four general categories:

- Potential conflicts that arise when proxy advisors provide services to both institutional investors and corporate issuers on the same subjects;
- Potential conflicts related to proxy advisors providing recommendations on shareholder initiatives backed by their owners or institutional investor clients;
- Potential conflicts when the owners, executives or staff of proxy advisory firms have ownership interests in, or serve on the boards of, public companies that have proposals on which the proxy advisors are making voting recommendations; and
- Potential conflicts when proxy advisory firms are owned by firms that provide other financial services to various types of clients.

ISS: Providing Voting Recommendations *and* Corporate Consulting Services. The proxy advisory firms have varying policies for dealing with conflicts of interest, and most of them disclose these policies on their public websites. Most of the proxy advisors argue that they will not accept consulting business from corporate clients because they believe this would constitute a conflict of interest. The prominent exception is ISS, where corporate consulting revenues constitute approximately 17 percent of total revenues and may represent a much larger fraction of that firm's profits.[6] A close review of the company's financial results strongly suggests that the revenue received from corporate issuers in ISS's consulting operations is subsidizing the proxy voting recommendation business, which has been squeezed by tighter profit margins and demands for discounts by institutional investors.

ISS consulting for corporate issuers involves predominantly corporate issuers renting the ISS computer model that determines acceptable share usage for equity plans and consulting as to how to structure equity plans and other resolutions subject to shareholder approval to improve the chances of a favorable recommendation under ISS's or institutional investor policies. ISS acknowledges the potential for a conflict of interest created by its corporate consulting and says that it maintains a "firewall" which separates the staff that perform proxy analyses and advisory research from its corporate consulting work and that this firewall includes "legal, physical and technological separations." In addition, ISS seeks to reinforce the separation by telling corporate clients that when they meet with proxy analysis staff, they should refrain from discussing

[6] Institutional Shareholder Services Inc. "Due Diligence Compliance Package," March 2010, p. 8 (ICS revenue in 2009 accounted for $24.6 million while 2009 income from operations was $10.9 million. Assuming high profit margins, ICS could account for a substantial share of ISS's earnings, leading to the reluctance of ISS to give up its consulting operations. *See also* RiskMetrics Group, 2009 Form 10-K Report, Feb. 24, 2010. On a product basis, Governance Services (mainly proxy research and voting) accounted for $92.4 million in revenues, while Financial Research and Analysis accounted for $52.3 million. ISS segment income from operations in 2009 was $10.9 million, up from a loss of $148.7 million in 2008, when results were negatively impacted by a $154.2 million non-cash write-down to ISS goodwill "primarily as a result of the negative equity market conditions which caused a material decline in industry market multiples in the second half of 2008" and a $5.9 million write-down related to an ISS product trademark.

whether the client has received consulting services from the other side of ISS.[7] Yet, there is a widespread belief, as the U.S. General Accounting Office stated in 2007, that "corporations could feel obligated to subscribe to ISS's consulting services in order to obtain favorable proxy vote recommendations on their proposals and favorable corporate governance ratings."[8]

Observers have questioned for years whether this so-called firewall is effective. For example, Graef Crystal, the former executive compensation consultant and critic, was quoted in the New York Times in 1994 as follows regarding ISS, "They've got a severe conflict when they work both sides of the street. It's like the Middle Ages when the Pope was selling indulgences. ISS is selling advice to corporations on how to avoid getting on their list of bad companies. There's a veiled sense of intimidation."[9] More recently, several major institutions have cited ISS's corporate consulting conflicts as a reason for switching proxy service providers.[10]

The Center recommends that the Commission prohibit proxy advisory firms from being able to offer advisory services to institutional investors while at the same time selling consulting services on the same topics to corporate issuers. The existence of corporate consulting creates the potential for improper conduct and at a minimum creates an appearance of favoritism toward ISS's consulting clients. At a minimum, ISS should be required to disclose in each proxy voting report, the amount received from a corporate issuer for consulting services, and issuers should be required to disclose the amount they spent on the ISS consulting business, consistent with the increased disclosure for the use of compensation consultants and other providers.

<u>Conflicts in Accepting Advisory Fees From Proponents of Shareholder Resolutions</u>. Another potential conflict is when proxy advisory firms accept fees from institutional investors – especially activist institutions – that propose shareholder resolutions asking companies to change compensation, governance or other policies. The conflict is that the advisors may provide a more favorable recommendation to proponents that use their services. To our knowledge, none of the proxy advisors has said that it will refuse advisory fees from shareholder proponent clients, however, since this group contains prominent pension funds and institutional investors that are the core clients of proxy advisory firms. A strong case can be made that the firms should disclose in their voting recommendations when a proponent uses the advisor's services and the fees paid for those services.

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[7] *See* ISS Governance Services Website "Engaging With ISS" last viewed at http://www.riskmetrics.com/policy/EngagingWithISS ("We request that in any communication you may have with ISS analysts, you do not disclose your identity as an ICS client or potential client, in order to protect the integrity of our research process.")
[8] U.S. Government Accountability Office, "Corporate Shareholder Meetings: Issues Relating to Firms that Advise Institutional Investors on Proxy Voting, GAO-07-765, June 2007, p. 10.
[9] Wayne Leslie, "Have Shareholder Activists Lost Their Edge?," The New York Times, Jan. 30, 1994, p. C7.
[10] *See, e.g.*, Dean Starkman, "A Proxy Adviser's Two Sides: Some Question Work of ISS for Companies It Scrutinizes," Washington Post, Jan. 23, 2006 (quoting a letter from Gary Findlay, Executive Director of the Missouri State Employees' Retirement System to ISS, stating "I see no merit in further wasting your time or mine regarding this issue. From this point forward, we will . . . engage an organization that at least has the appearance of undivided loyalty to . . . clients."). Similar concerns were voice by the Ohio Public Employees Retirement System and the Colorado Public Employees' Retirement Association in 2005 and the Ontario Teachers' Pension Plan in 2006. Edward F. Smith, "White Knight Swoops in for Glass Lewis, Directorship," Dec. 1, 2007.

Conflicts Based on Ownership, Directors, or Staff. Conflicts of interest may also arise when the owners, executives or staff members of proxy advisory firms have ownership interests in, or serve on the boards of, public companies that have proposals on which the proxy advisors are making voting recommendations. The temptation is for the owners to favor or to lean on the firm to favor, the public companies that they own. The Center believes that annual disclosure of these relationships in a public filing is the best way to enable clients to determine whether an impermissible conflict exists or has affected a proxy advisor's determination.

Conflicts in Ownership Structures. In addition, the four major proxy advisors – ISS, Glass Lewis & Co., Proxy Governance, Inc. and Egan-Jones Proxy Services – are all now part of larger organizations that offer multiple services, often to the same institutional investment firms that are typically the clients of proxy advisors. This enhances the potential for additional conflicts of interest, as the GAO noted in its study of the industry. The parent firms of the four major proxy advisors and examples of some of the businesses that they or their subsidiaries are engaged in are:

- MSCI (parent firm of ISS) – risk consulting, index creation and maintenance, investment analytics and tools.
- Ontario Teachers' Pension Plan (parent firm of Glass Lewis) – public and private equity investments, relationship investing.
- Foliofn (parent firm of Proxy Governance) – brokerage, custody, trading, compliance services, and trading platforms.
- Egan-Jones Ratings Co. (parent firm of Egan-Jones Proxy Services) – credit ratings services.

Current disclosure by proxy advisory firms is not adequate to address the problems created by actual conflicts of interest or the appearance of such conflicts. Proxy advisors typically address conflict of interest disclosure in two ways: through general policy statements on their websites or with statements in their reports that state that the firm may have received compensation or have a relationship with the firm that is the subject of the report and providing readers with instructions for obtaining more information if they are interested. These disclosure practices put the burden on the clients of proxy advisory firms to take actions to discover whether the proxy advisory firm may have a conflict on a specific matter and then to determine whether any safeguards instituted by the firm are sufficient to mitigate this conflict. There are considerable potential ramifications of a proxy advisory industry with readily recognizable conflicts of interest that wields great power over capital markets, and the market for corporate governance and control, while facing little regulatory oversight. This is particularly the case in the wake of the severe dislocations to the worldwide economy resulting from similar conditions found at the credit ratings agencies.

The Center believes that the Commission should impose more rigorous disclosure requirements to provide greater transparency regarding conflicts of interest in ownership structures and in use of proxy advisory firm voting recommendations by shareholder proponents. The Commission should mandate disclosures designed to make the financial relationships that underpin the most controversial aspects of the proxy advisory industry transparent to investors. Specifically, we recommend that the SEC require proxy advisory firms to disclose, in any report containing voting recommendations about a specific issuer, whether the firm has received consulting fees from either the issuer, or the proponent of a shareholder resolution on the ballot at that issuer, in the previous year and the amount of those fees. This disclosure should be located where it is easily accessible to any investor who is relying on the recommendations in the report and should be in tabular format to allow ease in identifying potential conflicts of interest.

In addition, the annual Form ADV filing required of proxy advisory firms by the SEC should also be strengthened by requiring proxy advisory firms to disclose the following:

- Total revenues provided in the previous year by corporate issuers on which the proxy advisor published analytic reports or recommendations and a list of those issuers with the specific fees provided by each issuer;
- Total revenues provided in the previous year by institutional investors who were proponents of shareholder proposals on corporate ballots and a list of those investors with the specific fees provided by each; and,
- A list of all public firms with which officers or directors of the proxy advisor, or its parent firm or affiliates, have investments exceeding a certain threshold or substantial business relationships.

In sum, the most egregious form of conflicts -- providing consulting services to the companies whose proxy disclosures an advisor is analyzing and providing recommendations – should be prohibited. Recognizing that it is not practical to ban all conflicts, however, the Center believes that greater disclosure of those conflicts and the underlying financial relationships as described above are essential.

V. Address Material Inaccuracies in Reports Provided by Proxy Advisory Firms

Based on survey data from the Center and reports from its Subscribers, existing procedures at proxy advisory firms are not sufficient to ensure the accuracy and completeness of proxy analyses. The Center believes that the SEC should explore this issue further and take steps to eliminate material inaccuracies. A recent survey of chief human resource officers conducted by the Center and its parent organization, HR Policy Association, found that 53% of the firms responding said that a proxy advisory firm had made one or more mistakes in a final published report in 2009 or 2010 regarding their company's compensation programs. Frequently mentioned mistakes in the survey included improper peer groups or peer group data, erroneous analysis of long-term incentive plans and inaccurate discussion of a company's policy, plan or benefits based on provisions no longer in effect.

Peer group data is especially important in how advisory firms make compensation decisions, and 57% of respondents indicated that the peer group failed to appropriately reflect the company's size, market or competitive position. Nearly all respondents – 96% -- indicated that the proxy advisory firms did not make any adjustments to the peer group in a final report transmitted to investors. If the quantitative determinations made by proxy advisors are based on an inappropriate peer group, the rest of the analysis can be improperly skewed, and this area merits further attention by the Commission.

An earlier 2010 survey by the Center sought to obtain more specific information on the inaccuracies in draft and final reports in the 2008 and 2009 proxy season. Specific examples include:

- Two proxy advisory firms miscalculated the total compensation by using the maximum opportunity for our performance share plan grant (three times fair market value on date of grant) compared with the target. One firm made the correction but the other did not correct the report, merely adding language to its report about the change in the final SEC disclosure rule which requires disclosure at the target level, not the maximum, in most cases.
- In 2008, a proxy advisory firm recommended a withhold vote against our Compensation Committee members based on our pay compared to their peer group. We called out that their analysis was based on our 2008 data versus the peer 2007 data, so it was not comparing pay over similar time periods.
- A proxy advisory firm's draft report last year was obviously a cut and paste from their report on another company as it included negative language about personal use of the company aircraft, which our company did not have.
- A Subscriber reported that it received drafts from two proxy firms within a few days of the proxy votes, so there was no time for correction. One firm corrected their errors and re-issued it after many of the votes were already in and committed to giving us more advance review time in future. A larger firm was difficult to track down and when we did, they made no promises about lead time in the future and made no changes. Neither of the firms had a policy to allow review time by the company prior to issuance.

These inaccuracies rise above mere differences of opinion or in application of policy. In many cases, they are simply the result of failure to read the proxy statement. Similar material misstatements or errors in an issuer's disclosure would trigger SEC review or an enforcement action.

Because institutional investors have come to rely so heavily on the information and recommendations provided by proxy advisory firms – and because proxy votes on many issues, from director elections to approval of compensation plans, carry more weight than they have previously– errors or inaccuracies in proxy reports are now capable of causing significant harm to corporations and their investors. In recent years, for instance, the percentage of equity plans that ISS has recommended voting against has hovered around 30 percent.[11] If any significant percentage of these recommendations were based on erroneous or inaccurate data, as the above data suggests, then inaccuracies at ISS are negatively impacting the compensation programs at a meaningful number of companies. Moreover, the influence of proxy advisors on corporate governance and compensation is poised to grow further with the addition of mandatory say on pay votes and proxy access.

The Center recommends that the Commission require the following to minimize and mitigate what appears to be a growing number of inaccuracies in proxy advisor research reports:

- Rules requiring proxy advisory firms to seek input from issuers on draft versions of proxy research reports.
- Public disclosure by proxy advisors of error rates and the number of times that published reports require corrections.
- Where errors are based upon a fundamental disagreement in interpretation, providing an opportunity for an issuer to provide a "dissenting statement" in a report so that investors fully understand the context of the proxy advisor's recommendation and the company's rationale for its approach.
- Greater regulatory oversight of inaccuracies in proxy reports and their actual and potential consequences.

Delayed public disclosure of all voting recommendations by proxy advisors would allow investors and academics to better assess whether the voting recommendations of proxy advisory firms were in accordance with the views of mainstream institutional investors and to compare and contrast the voting records of the major proxy advisors.

VI. The Impact of the Lack of a Competitive Market Structure

The competitive structure of the proxy advisory industry is highly concentrated and best described as a near-monopoly, with one firm, Institutional Shareholder Services, or ISS, dominating an industry comprised of four players. ISS has been a serial acquirer of other firms in the industry. Since its founding in 1985, it has acquired or merged with at least eight other proxy and governance research firms, greatly limiting its potential competition and adding a suite of products designed to complement its proxy advisory business.

Despite the frequently cited ease of having competitors entering the market, this market situation encourages a number of anti-competitive results. The dominance of ISS has made the continued survival of other firms in the industry tenuous and discouraged new entrants to the industry. By greatly limiting the potential revenues available to its rivals – often through selective price-cutting for clients who are considering using another firm – ISS appears to have

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[11] *See, e.g.,* Equity Plan Proposal Failures: 2007-2009, Exequity and Altman Group, June 2010, at 2. (RMG typically "grades on a curve" and strives to recommend against a third of all of equity plan proposals. In recent years, RMG has fallen a bit below that target, recommending against 25 to 30 percent of equity plan proposals.")

put the survival of at least some of its competitors in question. One competitor, Proxy Governance Inc., has publicly noted the anti-competitive practices of ISS. In a 2008 public letter to the Millstein Institute for Corporate Governance and Performance, Proxy Governance noted:

> Although the public policy of this country is to encourage competition in any lawful form, it is generally accepted in antitrust circles that any near-monopolist must operate under certain constraints to ensure that its business practices are not designed to eliminate competition. For example, RiskMetrics/ISS has the market power, given its scale, to undercut any price either PROXY *Governance* or Glass Lewis may quote to a potential customer, including existing clients of RiskMetrics/ISS. In fact, in our experience, when RiskMetrics/ISS is in danger of losing a client, rather than lose that client it will very substantially reduce its price quotation to a level where it would be uneconomic for a competitor to serve that client. In addition, or in the alternative, it will frequently make available at little or no cost other products or services that its smaller competitors do not offer.

The competitive structure of the industry has also no doubt impacted the quality of recommendations provided by proxy advisory firms. There are several reasons for this, including the desire by institutional investors to keep this cost down to a minimum while satisfying their fiduciary duties to vote their client's proxies. Some proxy advisory firms have undergone significant staff downsizings as a result of continuing concerns about operating losses or profitability.

Finally, the dominant position of ISS in the industry also has had the effect of giving it the market power needed to sell its corporate consulting services. Without its dominant market position on the investor advisory side, there would be no real need or incentive for corporations to buy its consulting services. But knowing that its vote recommendations and governance ratings can be decisive in influencing a significant percentage of votes by major shareholders, many corporations feel that they have little choice but to pay consulting fees to ISS to determine whether their compensation plans will pass muster. These consulting fees may now be the primary source of ISS' profitability, which may allow it to price its institutional advisory services at a level that makes it more difficult for other firms to compete with it.

The lack of a competitive market structure is an area ripe for SEC review and action. As discussed above, by prohibiting the consulting services provided by ISS, the industry will be re-focused on how to provide the best proxy analysis and voting recommendations possible for institutional investors. Likewise, the Commission needs to reinforce through regulation the current responsibility of institutional investors to monitor the proxy advisors, whose recommendations are incorporated into their voting decisions. As Charles Nathan has opined, most institutional investors have split the roles of investment management from proxy voting, but the split may not fulfill investor fiduciary duties.[12]

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[12] Charles M. Nathan, "The Parallel Universes of Institutional Investing and Institutional Voting" and "The Future of Institutional Share Voting: Three Paradigms," Harvard Law School Forum on Corporate Governance and Financial Regulation," April 6, 2010, and July 23, 2010. ("The effectiveness of this model rests on the assumption

VII. Center Recommendations for Greater Regulation of the Proxy Advisory Industry

Additional regulation of proxy advisory firms is necessary and appropriate for several reasons. Like the credit ratings agencies, proxy advisors play an important role in the proper functioning and oversight of U.S. capital markets, including the market for corporate control. Their power and influence has recently been expanded by legislation such as the Dodd-Frank Act, which requires all U.S. companies to hold advisory say-on-pay votes to approve executive compensation programs. Yet, also like credit ratings firms, they suffer from conflicts of interest, a lack of transparency regarding their methodologies and inaccuracies in reporting that have the potential to cause serious harm to issuers and investors. Moreover, they are subject to little regulatory oversight.

Proxy advisors should therefore be required to register with the SEC under the Investment Advisers' Act. The standard should apply to all proxy advisors that make voting recommendations and meet certain minimum criteria for the number of clients they serve.

Even if all proxy advisory firms were required to register, however, the current regulatory requirements for Registered Investment Advisers do not effectively address the principal areas of concern about the proxy advisors; namely, their well-documented conflicts of interest, lack of transparency and inaccuracies in their reports. We believe that in addition to requiring these firms to register, the SEC should take the following steps to address concerns about the proxy advisors:

1. Ban the practice of firms providing proxy advisory services to investors while simultaneously selling consulting services to corporate issuers on the same, or substantially similar, subject matters.
2. Require full disclosure by proxy advisors, in any report containing voting recommendations about a specific issuer, whether the firm, or its parent or affiliates, or the officers or directors of any of these entities, has received fees from either the issuer, or the proponent of a shareholder resolution on the ballot at that issuer, in the previous year and the amount of those fees. This disclosure should be located where it is easily accessible to any investor who is relying on the recommendation in the report and should be in tabular format to allow ease in identifying potential conflicts of interest. In addition, a summary report of all such fees and business relationships should be required to be included in the annual Form ADV reports filed by proxy advisory firms.

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that voting decisions can be delegated to specialists and third party proxy advisors so as to fulfill the institution's fiduciary duties without imposing undue costs on the institution. It is not clear, however, that the parallel voting universe that has evolved over the past 25 years successfully discharges institutional investors' fiduciary duties of due care and loyalty.")

3. Require institutional investors who submit shareholder proposals for inclusion on corporate proxy statements to disclose whether they have paid fees to a proxy advisor in the previous year, the amount of those fees and the services they obtained.
4. Require corporations to disclose in their annual proxy statement whether they have paid fees to a proxy advisory firm in the previous year, the amount of those fees and the services they obtained.
5. Require the SEC to do periodic reviews of proxy advisory firm research reports to check for accuracy and completeness, much the way the SEC currently does for company filings every three years under Sarbanes-Oxley.

Conclusion

The Center On Executive Compensation appreciates this opportunity to provide comments on the state of the proxy voting system and specifically the role of proxy advisor firms. If you have any questions about these comments, please contact me at tbartl@execcomp.org.

Sincerely,

Timothy J. Bartl
Senior Vice President and General Counsel

cc: Securities and Exchange Commission
Hon. Mary L. Schapiro, Chairman
Hon. Kathleen L. Casey, Commissioner
Hon. Commissioner Elisse B. Walter, Commissioner
Hon. Commissioner Luis A. Aguilar, Commissioner
Hon. Commissioner Troy A. Paredes, Commissioner

Securities and Exchange Commission -- Division of Corporation Finance
Ms. Meredith Cross
Ms. Paula Dubberly