Statement of

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Institutional Shareholder Services Inc.

to the

Subcommittee on Capital Markets and Government Sponsored Enterprises

Committee on Financial Services

United States House of Representatives

May 17, 2016

Legislative Proposals to Enhance Capital Formation,

Transparency and Regulatory Accountability

To: Chairman Garrett and Ranking Member Maloney:

Institutional Shareholder Services Inc. ("ISS"), a proxy adviser for more than thirty years and a federally registered investment adviser for almost two decades, is pleased to submit this statement for the record in today's hearing with regard to proposed legislation to be known as the "Proxy Advisory Firm Reform Act of 2016."

Executive Summary

Over the past several years, proxy advisers have, themselves, become a proxy for the debate over the proper role of shareholders in corporate governance and the voice that shareholders should have in the companies they own. The Securities and Exchange Commission's ("SEC") 2013 Roundtable on proxy advisory firms highlighted the clear philosophical divide between investors and corporate management on this issue. Investor representatives at the Roundtable emphasized the importance of voting their shares as "a duty of good corporate citizenship"[1] and the critical role proxy advisers play in aggregating, synthesizing and making sense of the vast array of data found in proxy statements.[2] Participants representing corporate issuers, on the other hand, suggested divestment as an alternative to voting proxies against management,[3] and accused ISS of being conflicted because its subsidiary provides services to issuers, while at the same time accusing ISS of being in the pocket of activist shareholders.[4]

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1 Remarks of Eric Komitee, General Counsel, Viking Global Investors, LP, Transcript of Proxy Advisory Firms Roundtable (December 5, 2013) ("Roundtable Transcript"), available at www.sec.gov/spotlight/proxy-advisory-services/proxy-advisory-services-transcript.txt at 74.

2 Remarks of Michelle Edkins, Managing Director and Global Head, Corporate Governance and Responsible Investment, BlackRock, Inc., *Id.* at 45; remarks of Damon Silvers, Director of Policy and Special Counsel, AFL-CIO, *Id.* at 63.

3 Remarks of Trevor Norwitz, Partner, Wachtell, Lipton, Rosen & Katz, *Id.* at 66.

4 *Id*. at 101-104.

The proxy adviser bill being considered by the Subcommittee today clearly sides in this ongoing debate with self-interested corporate managers and their lobbyists over the interests of tens of millions of hard-working Americans who entrust their retirement and investment dollars to pension funds, mutual funds, asset managers and other fiduciaries who hire proxy advisers. The proposed legislation would move proxy advisers out of a well-established investor-centric federal regulatory regime to a brand new bureaucratic maze that is designed to allow corporate executives and their representatives to pressure proxy advisers to back management positions on issues ranging from CEO compensation and director elections to mergers and insider-led leveraged buyouts. In so doing, the bill would weaken, or perhaps even destroy, the existing fiduciary bond between proxy advisers and their shareholder clients and would disharmonize rules that apply to proxy advisers from those that apply to the investment managers and pension fiduciaries who use their services.

While many aspects of the bill merely duplicate existing regulatory requirements (which ISS, as a registered investment adviser, already satisfies), other aspects would make it impossible, as a practical matter, for proxy advisers to provide timely research on the broad universe of shareholder meetings they cover for their clients today. In this way, the bill would deprive shareholders of the key information they need to make informed voting and investment decisions in accordance with their own fiduciary duties and other mandates. Furthermore, by encouraging meritless litigation from disgruntled issuers, the legislation may undermine the independence, quality, timely delivery and integrity of proxy research.

Finally, in light of the Subcommittee's clear interest in ensuring the cost effectiveness of SEC regulation, we note that directing the SEC to abandon an existing set of regulations and promulgate new rules for a tiny industry comprised of a handful of entities cannot, by any stretch of logic, be considered cost-effective. The proposed mandatory regime for proxy advisers appears to be modeled on the regime established for credit rating agencies 10 years ago. However, that regulatory model is inapposite to proxy advisers, because rating agency registration is not mandatory, but rather is used only by firms who wish to be known as "nationally recognized." Moreover, unlike the credit rating agency business model in which issuers select and pay for the research and ratings disseminated about them, it is the *investors* who choose and pay proxy advisers for their research and recommendations. Finally, proxy advisers are fiduciaries, and rating agencies are not.

ISS respectfully submits that if passed, the proposed legislation would inappropriately tip the debate over the proper role of shareholders in corporate governance in favor of entrenched corporate interests at the expense of shareholders and free-market capitalism. It would do so in a very costly, inefficient and counter-productive manner. As a result, shareholders would be deprived of their freedom to choose the tools, services and information they need to be good corporate citizens.

ISS' VIEWS ON THE PROPOSED LEGISLATION

A. There is No Need for This Bill.

The litmus test for any federal legislative intrusion into the free market is whether it targets a significant problem and seeks to address it in the most cost-effective fashion. Not only does this proposed bill fail on both of these counts, but it would actually create a costly new problem by hampering institutional investors' efforts to meet their fiduciary responsibilities with respect to monitoring the companies in their portfolios and voting their shares in an informed fashion. The proposed legislation rests on a shaky foundation built from (i) factual inaccuracies about the proxy advisory industry conjured up by corporate lobbyists; (ii) complaints from a small cadre of self-serving corporate executives who would prefer immunity from investor scrutiny; and (iii) failure to comprehend the robustness of the existing regulatory oversight structure that already applies to ISS, as well as the success of ongoing efforts by U.S. and global regulators and the industry itself to foster best practices in the industry.

1. Shareholders Are Not Overly Reliant on Proxy Advisers.

Into the first category falls the two-part inaccuracy that investors are overly reliant on the voting advice of proxy advisory firms, instead of relying on portfolio managers who have a fiduciary duty to investors and use independent judgment in exercising shareholder votes.[5] The lobbyist-promulgated myth that proxy advisers are omnipotent and that the investors who use them are puppets who mindlessly do as they are told was thoroughly vetted and discredited at the SEC Roundtable.

It was evident from the Roundtable that if improper use of proxy advisers even occurs, it is the rare exception rather than the rule. Supporters of more regulation of proxy advisers typically present little more than untraceable anecdotes, unsubstantiated rumors or unrecognizable

[5] H. R.__, the "Proxy Advisory Firm Reform Act of 2016 (Duffy) (cited hereafter as the, "Proxy Advisory Reform Act"), Sec. 2.(4).

caricatures of “small investment advisers” as their evidence of “abuses” to justify their calls for intervention into the contractual relationships between institutional investors and their selected proxy advisers. In sharp contrast, the real institutional investors featured at the SEC’s Roundtable certainly appear to take their fiduciary responsibilities regarding proxy voting very seriously, and they understand their duty to vote proxies in their clients’ or beneficiaries’ best interests.[6] With regard to the practices of small investment advisers, Karen Barr of the Investment Adviser Association noted that although some small firms may rely on proxy advisers more extensively than do large advisers with dedicated research staff of their own, thousands of small firms do not use proxy advisers at all.[7]

As the sponsors of the proposed legislation grudgingly acknowledge in their preamble, proxy advisers’ research and vote recommendations are just one source of information used in arriving at the institutions’ voting decisions. Many investors have internal research teams that conduct proprietary research and use proxy advisory research to supplement their own work.[8] Some investors use third-party proxy research as a screening tool to identify non-routine meetings or proposals. A number of institutional investors use the services of two or more proxy advisory services. These views are consistent with the results of a recent survey of asset managers by Tapestry Networks that found proxy advisory firms’ “role as data aggregators” has become increasingly important to asset managers, and that even if smaller managers are more reliant on such advisory firms, they still acknowledge that responsibility for voting outcomes lies with

[6] Remarks of Michelle Edkins, Roundtable Transcript at 45 (“BlackRock typically uses research and other data services from proxy advisory firms as one of many inputs in our proxy voting decisions We use the firms primarily to synthesize the vast array of data that you get in proxy statements, and more than just synthesize it, to put it in a consistent format”).

[7] *Id* at 56.

[8] Remarks of Anne Sheehan, *Id.* at 153-54; remarks of Lynn Turner, Managing Director, LitiNomics, Inc., discussing his experience at Colorado PERRA, *Id.* at 51-52.

investors.[9] The fact that institutional investors do not blindly take direction from proxy advisers is demonstrated by the fact that these investors often vote against the recommendations of their proxy advisers.[10]

Further, while another participant at the SEC Roundtable, Mark Chen, Associate Professor of Finance, Georgia State University, noted a high correlation between proxy advice and vote outcomes, he was unable to state whether that correlation derives from large investors' outsourcing their voting decisions to proxy advisers or from the fact that voting advice brings important new information to the markets.[11]

This latter view has been endorsed by other academics. In their paper, *The Power of Proxy Advisors: Myth or Reality?,*[12] University of Pennsylvania Law School Professor Jill Fisch, along with colleagues from New York University, analyzed the effect of proxy adviser recommendations on voting outcomes in uncontested director elections. The authors estimate that, after controlling for underlying company-specific factors that influence voting outcomes, an ISS recommendation appears to shift 6 to 10 percent of shareholder votes, but that this influence may stem from ISS' role as information agent:

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[9] Bew, Robyn and Fields, Richard, Voting Decisions at US Mutual Funds: How Investors Really Use Proxy Advisers (June 2012) at 2. Available at SSRN: http://ssrn.com/abstract=2084231. ("Across the board, participants in our research said they value proxy firms' ability to collect, organize, and present vast amounts of data, and they believe smaller asset managers are more reliant on those services. Nonetheless, participants emphasized that responsibility for voting outcomes lies with investors").

[10] *See, e.g,* remarks of Michelle Edkins, *Id.* at 50 (for "say on pay votes" in 2012, BlackRock voted against four percent of the proposals, while their proxy advisers recommended no votes on roughly 16 percent of the proposals); remarks of Lynn Turner, *Id.* at 53 (CoPERA voted against Glass Lewis's director recommendations 52 percent of the time; "Glass Lewis actually voted with management a lot more often than we did."); remarks of Eric Komitee, *Id.* at 75 ("[T]here are certainly times where we disagree with the proxy advisory services"). *See also Id.* at 153.

[11] *Id.* at 39-41.

[12] Choi, Stephen J., Fisch, Jill E. and Kahan, Marcel, The Power of Proxy Advisors: Myth or Reality? 59 Emory L. J. 869 (2010); University of Pennsylvania, Institute for Law & Economics Research Paper No. 10-24. Available at SSRN: http://ssrn.com/abstract=1694535.

[W]e find evidence that ISS's power is partially due to the fact that ISS (to a greater extent than other advisors) bases its recommendations on factors that shareholders consider important. This fact and competition among proxy advisors place upper bounds on ISS's power. Institutional Shareholder Services cannot issue recommendations arbitrarily if it wants to retain its market position. Doing so would lead institutional investors to seek the services of other proxy advisory firms. Thus, ISS is not so much a Pied Piper followed blindly by institutional investors as it is an information agent and guide, helping investors to identify voting decisions that are consistent with their existing preferences.[13]

The investor representatives participating at the Roundtable had their own theories about the correlation between proxy adviser vote recommendations and actual votes cast. Two participants suggested that the large institutional investors and proxy advisers have common views about corporate governance,[14] while another observed that the SEC and the DOL would likely be concerned if institutional investors were spending money on proxy advisory services they found to be of no value.[15]

Of course, another reason for the correlation between recommendations and votes cast is that, as explained in the appendix to this statement, proxy advisers in many instances base recommendations to their clients on the clients' own custom voting policies.

The fallacy in the second part of the finding about over-reliance on proxy advisers – that proxy advisers, unlike portfolio managers, do not have a fiduciary duty to investors and do not utilize independent judgment when rendering proxy voting advice – is exposed by the explanation in the appendix to this statement of the Advisers Act regulatory regime. As it stands today, investors have double fiduciary protection, a benefit that would be lost under the proposed legislation.

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13 *Id.* at 906.

14 Remarks of Lynn Turner, Roundtable Transcript at 54; remarks of Eric Komitee, *Id.* at 152-53 ("I think it is possible . . . that a lot of the statistics that show a correlation between their recommendations and the outcome of a vote are because the ultimate voters . . . think in the same way that the proxy advisory services do about director performance and other similar subjects, not because we're voting blindly with them and not because we're even necessarily persuaded by their reasoning so much as just because we happen to think that way to begin with.").

15 Remarks of Damon Silvers, *Id.* at 63.

2. The Commission Already Has Statutory Authority to Oversee the Proxy Advisory Firm Industry.

While ISS agrees that oversight of proxy advisers serves a compelling interest of investor and shareholder protection,[16] the proposed legislation's finding that the SEC needs new statutory authority to exercise that oversight is clearly erroneous. Congress gave the SEC that authority over 75 years ago in the Advisers Act. As discussed in more detail in the appendix, the SEC has used that authority to develop a very robust regulatory regime that governs *all* investment advisers, including those whose advice pertains only to proxy votes and other matters of corporate governance.

3. From an Investor Perspective, Proxy Advisers Have A Salutary Effect on Corporate Governance, the Securities Markets and the National Economy.

The proposed legislation finds both that the services rendered by proxy advisers have "assumed outsized importance in the national debate over high-quality corporate governance;"[17] and that investor reliance on these services has a substantial effect on corporate governance, the securities markets, and the national economy.[18] ISS respectfully submits that from an investor perspective, the first of these statements is untrue and the second statement describes not a problem to be solved, but a success of private ordering that should be applauded.

Proxy advisers have not "assumed" an outsized importance in the debate over corporate governance, so much as they have been an outsized target in obsessive efforts by a small number of corporate managers and their representatives to discourage institutional investors from using their voice in the corporate governance debate. Because these parties legally cannot stop the investors from exercising their franchise rights, they seek to make it more expensive,

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[16] Proxy Advisory Firm Reform Act, Sec. 2.(7).

[17] *Id.,* Sec. 2.(3).

[18] *Id.,* Sec. 2.(5).

cumbersome and time consuming to reach informed voting solutions. Information is equivalent to oxygen for proxy voters, so entrenched managers seek to cut off its supply.

B. The Proposed Legislation Would Impair or Destroy the Fiduciary Relationship Between Proxy Advisers and Shareholders.

Having failed to identify any need to upend the established regulatory framework governing proxy advisers, we next turn our attention to the overall effect the proposed new regulatory regime would have on the millions of hard-working Americans who entrust their retirement and investment dollars to pension funds, mutual funds, asset managers and other fiduciaries who hire proxy advisers. There can be no doubt that this regulatory regime would redirect proxy advisers' focus away from the best interests of investors in favor of placating corporate managers.

Disguised as a safeguard of the "reliability" of proxy advisory services, proposed new Exchange Act Section 15H(h) would compel proxy advisers to furnish the subjects of proxy recommendations "reasonable" access to drafts of those recommendations and an opportunity to provide "meaningful" comment thereon, including the opportunity to present "details" to the person(s) responsible for developing the recommendations. This provision would also require proxy advisers to employ an ombudsman to receive complaints about the "accuracy" of voting recommendations from the subjects of those recommendations, and would forbid voting on the matter in question until those complaints are resolved.

Enforcement of this directive to cede control over the content of proxy reports and recommendations to the subject of those reports and recommendations would not rest solely with the SEC, but would extend to corporate issuers as well. Proposed Exchange Act Section 15H(n)(2) would afford any subject of a proxy adviser's vote recommendation who felt "aggrieved" by the adviser's failure to fully comply with Section 15H(h) and rules thereunder to sue the proxy adviser in Federal district court for equitable relief, money damages or "such other relief determined by the court to be appropriate."

The problems with these provisions are not hard to see.

First, it is impossible from an operational standpoint for a proxy adviser like ISS that annually covers more than 39,000 shareholder meetings to afford each issuer the opportunity to review a draft proxy report for factual accuracy prior to the delivery of that report to clients. As explained in the attached appendix, the window between the release of the proxy statement and the shareholder meeting is almost completely filled with the adviser's analytical activities and shareholder review of the report and recommendation.[19] The limited issuer review process that ISS currently manages to squeeze into this tight timeframe would not begin to satisfy the unrealistic expectations of the proposed legislation. In order to satisfy demands like these, ISS would have to severely limit its coverage, leaving shareholders without access to the critical information and services they need to have a meaningful voice in corporate governance. Smaller proxy advisers could be driven out of the market altogether. However, even if it were operationally possible to offer a draft review to 39,000 companies, the power given to issuers in this bill is disturbing.

Proposed Section 15H(h) seems to be intentionally riddled with highly subjective terms like "reasonable" access, "meaningful" comment and presentation of "details," as well as the opportunity to complain about the "accuracy" of vote recommendations.[20] The ultimate power to define these terms would transfer to self-interested corporations, which, for example, could prevent investors from receiving valuable information from a proxy adviser regarding voting on a contested issue simply by refusing to allow the proxy adviser to "resolve" their complaints. As such, the legislation would create a virtually open-ended legal liability that smaller proxy advisory firms would probably be unable to bear.

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[19] *See* discussion at Appendix, Section A.3.

[20] ISS is at a loss to understand how an issuer could label a vote recommendation as "accurate" or "not accurate." As explained in the attached appendix, ISS often provides clients with diametrically opposite recommendations, depending on the particular needs and interests of its shareholder clients and the proxy voting guidelines those clients have selected.

Proxy advisers who strive to conduct independent analyses and issue vote recommendations in the best interests of their investor clients (whatever those interests might be), would labor under the constant threat of litigation from disgruntled issuers. The specter of being hauled into Federal court would have a chilling effect on these advisers' independence. Advisers who stand their ground could find themselves sued out of existence.

Given that what issuers consider to be factual errors are often philosophical differences or outright disagreement with voting policies,[21] it does not take much imagination to see that the proposed legislation is a thinly-veiled effort to give corporations effective veto-power over any vote recommendations they do not like. *Corporate issuers are not now and should not ever be the arbiters of proxy voting advice.*

C. The Proposed Legislation Would Establish a Regulatory Regime That In Some Respects Duplicates and In Other Respects Is Weaker Than the Regime That Governs Proxy Advisers Today.

The proxy adviser regime proposed to be established under new Section 15H of the Exchange Act would entail a formal registration application process with periodic updates and annual certifications; a requirement to make registration information publicly available; the designation of a compliance officer; and the adoption of written policies and procedures to address conflicts of interest. As explained later in this Statement, each of these requirements is already contained in the Advisers Act regulatory regime.[22]

In many cases, the protections afforded to investors under the Advisers Act are stronger than those included in the new scheme. The most glaring example of this is that while the proposed regime pays lip service to managing conflicts of interest, it also embeds an inherent conflict into the governing statute. So long as the subjects of proxy advisory reports are given *de*

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[21] *See* Appendix, note 5, and accompanying text.

[22] *See* Appendix, Section B.2.

facto editorial control over what is said about them, there will be conflicts that will be difficult to mitigate under any proxy adviser's conflict of interest policies and procedures. Registered investment advisers, by contrast, are not statutorily compelled to serve two masters; their fiduciary duties of care and loyalty run only to their clients, the investors.

Furthermore, whereas registered investment advisers are required to maintain codes of ethics establishing standards of corporate behavior and personal trading controls,[23] Exchange Act proxy advisers would be obliged only to state whether they have a code of ethics, and if not, why not.[24] Although Exchange Act proxy advisers would have to post their registration information on their own websites, registration documents for all investment advisers are accessible in one location through the SEC's website, making it easy for investors to comparison shop. Finally, unlike the Advisers Act, the proposed legislation entails no market protections against insider trading, or client protections relating to sales and marketing or contracts, and no books and records requirements.

Overall, the proposed regulatory scheme is a pale imitation of the one that exists today.

D. Credit Rating Agency Regulation is the Wrong Model for Proxy Advisers.

The proxy adviser bill appears to be modeled on the Credit Rating Agency Reform Act that Congress passed ten years ago. That law established a registration scheme for credit rating agencies wishing to be designated as Nationally Recognized Statistical Rating Organizations ("NRSROs") so that their credit ratings could be used for a host of regulatory purposes. The NRSRO concept had its genesis in the broker-dealer net-capital rule which the SEC promulgated under the Exchange Act in 1975, and references to NRSRO ratings eventually appeared in a number of laws and rules.

[23] *See* discussion at Appendix Section B.2.c.

[24] Section 15H(b)(1)(B)(iii).

NRSRO designation was achieved historically through a no-action letter process administered by the Staff of the SEC's Division of Market Regulation (now, Trading and Markets). Over time, this process was criticized as opaque and ineffective, and was seen as contributing to concentration in the market for credit ratings. To address this situation, the 2006 rating agency statute provided a formal regulatory regime with a standardized registration process that encompassed many of the same factors that had been used in the no-action letter era.

Although several provisions from the specialized NRSRO regime have found their way into the proxy adviser bill,[25] the rating agency regime is completely inapposite to the services provided by proxy advisers. To begin with, NRSRO registration is still voluntary. The only credit rating agencies who must register are those who wish to call themselves "nationally recognized." The proxy adviser bill, on the other hand, would force all proxy advisers into the bureaucratic maze of a brand new set of ill-fitting rules and regulations.

Furthermore, unlike NRSROs who were birthed by the Exchange Act, the regulatory home of investment research providers like proxy advisers has always been the Advisers Act. While the proposed legislation attempts to forge a bond between the Exchange Act and proxy advisers by calling them proxy "solicitors," proxy advisers do not "solicit" proxy votes, as explained more fully in the appendix to this statement.[26] In addition, proxy advisers are fiduciaries, which NRSROs are not.

Finally, and perhaps most importantly, NRSROs and proxy advisers operate under completely different business models. NRSROs are paid by the issuers who are, or whose debt is,

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[25] Curiously absent from the proposed legislation, however, is the rating agency provision that safeguards the First Amendment rights of NRSROs. Exchange Act Section 15E(c)(2) forbids the SEC from regulating "the substance of credit ratings or the procedures and methodologies by which any nationally recognized statistical rating organization determines credit ratings." ISS wonders if this omission is linked to Section 15H(h)'s mandate that issuers get to oversee the content of proxy research and recommendations.

[26] *See* discussion at Appendix, Sections A.1. and B.4.

the subject of the credit ratings, while proxy advisers are paid by the investors they advise.

For all these reasons, ISS respectfully submits that the proposed legislation is not only in the wrong pew, but is in the wrong house of worship altogether.

E. The Proposed Legislation Is Not Cost-Justified

ISS shares the Subcommittee's concerns about runaway costs in federal securities regulation and applauds the Subcommittee's efforts to ensure that benefits always outweigh costs in SEC rulemaking. That being the case, ISS is, frankly, surprised that the Subcommittee would even consider directing the SEC to turn its back on 75+ years of hard work crafting the Advisers Act regime, and launch a new round of rulemaking for an industry that consists in the U.S. of only 2 large and 3 small proxy advisers.[27] Requiring proxy advisers who comply with the robust Advisers Act regulatory regime today to pay for a new, untested registration scheme would confer no countervailing benefit on investors, and could very well drive the smaller proxy advisers from the market.

CONCLUSION

For all these reasons, ISS believes that the Proxy Advisory Firm Reform Act of 2016 is not an investor-protection piece of legislation, but rather is a thinly-veiled effort to deprive shareholders of a meaningful voice in corporate governance. ISS further believes that the bill would force

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[27] Passing laws without a realistic appreciation for economic consequences has led to a situation today in which the congressionally mandated SEC office that regulates NRSROs is roughly five times larger than the number of registrants that office regulates. And the cost of that regulatory regime appears to be limiting the pool of registrants. See Nationally Recognized Statistical Rating Organizations, SEC Rel. No. 34-72936, at 46-47 (Aug. 27, 2014), 79 Fed. Reg. 55078, at 55093 (Sept. 15, 2014) ("As a result of the amendments and new rules being adopted today, the number of credit rating agencies registered with the Commission as NRSROs may decline if current registrants believe that the cost of being registered and being subject to these new requirements outweighs the benefit of registration. The barriers to entry for credit rating agencies to register as NRSROs may rise, discouraging credit rating agencies from registering as NRSROs. . . .Also, if compliance costs significantly erode profit margins for NRSROs, the barriers to exit from being registered as an NRSRO in certain or all classes of credit ratings may lower. The risk for deregistration may likely be higher for smaller NRSROs.")

government regulators to waste resources re-creating rules they already have, and would impose costs on proxy advisers that could drive small firms from the industry.

Appendix in Support of ISS' Written Statement to the May 17, 2016 Hearing of the Subcommittee on Capital Markets and Government Sponsored Enterprises Committee on Financial Services of the United States House of Representatives

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PROXY ADVISERS AND THEIR REGULATION

A. Background

1. ISS' Proxy Advisory Services

Founded in 1985, in an era of aggressive financial market practices such as corporate raiding, greenmail and the unilateral adoption of poison pill takeover defenses, ISS responded to a demand by shareholders for assistance in exercising a meaningful voice in the governance of portfolio companies. Today, ISS is the world's leading provider of corporate governance and socially responsible investment solutions for asset owners, asset managers, hedge funds, and asset service providers. As part of its suite of offerings, ISS serves as a full-service proxy adviser that helps institutional investors make informed proxy voting decisions, manage the complex process of voting their shares and report their votes to their stakeholders and regulators. ISS annually covers more than 39,000 shareholder meetings -- every holding in ISS' clients' portfolios -- in over 110 developed and emerging markets worldwide.

All proxy analysis at ISS is undertaken in accordance with a publicly disclosed analytical framework comprised of voting policy guidelines chosen by ISS' clients. ISS offers a wide range of proxy voting policy options, including both a standard benchmark policy focused solely on protecting shareholder value and mitigating governance risk, and a wide array of specialty policies that evaluate governance issues from the perspective of sustainability, socially responsible investing, public pension funds, labor unions or mission and faith-based investing. Case-by-case analytical frameworks, which take into account company size, financial performance and industry practices, drive the vast majority of ISS' vote recommendations, such as those pertaining to the election of corporate directors and compensation matters.

ISS also makes and implements proxy voting recommendations based on clients' specific customized voting guidelines, and may assist clients in developing such custom guidelines as well. In fact, ISS currently implements nearly 500 custom voting policies on behalf of close to 400 institutional investors. Year-to-date, 68 percent of the ballots processed by ISS on behalf of clients globally were voted under clients' custom policies, representing 82 percent of the total shares processed by ISS during this period.

As a complement to its proxy analyses, ISS also serves as a data aggregator, currently capturing and synthesizing hundreds of data points that are used by institutional investors in investment-decision making, engagement with portfolio companies, and other initiatives tied to the discharge of their fiduciary duties as good stewards of working Americans' retirement and other savings.

In addition to advisory services, ISS also provides ballot processing and data management services that allow institutions to outsource these elements of their proxy voting operations. To this end, ISS often receives clients' ballots, coordinates with their custodian banks, processes votes based on client instructions, maintains voting records and provides reporting services. By outsourcing these burdensome administrative tasks, clients free themselves to devote more of their internal resources to making informed voting decisions.

As important as understanding what a proxy adviser like ISS does is comprehending what it does *not* do. First, ISS is generally not a discretionary proxy voting manager. Except in extremely rare situations where a client has an actual conflict of interest (for example, a financial institution that holds and must votes the shares of its parent company), and asks ISS to make a proxy voting decision on the client's behalf, ISS clients control both their voting policies and their vote decisions.

Nor does ISS engage in proxy "solicitation" as that term is used in Section 14 of the Securities Exchange Act of 1934 ("Exchange Act"). As a disinterested fiduciary of its shareholder clients, ISS has no financial stake in the outcome of a particular vote, and is agnostic as to whether its clients support or reject a proxy proposal or abstain from voting altogether. ISS' only job is to analyze proxy statements and provide clients with informed research and vote recommendations based on the policies and guidelines the clients have already selected. Given the diversity of these policies and guidelines, ISS may issue opposing recommendations on a given issue by, for example, recommending "FOR" to a pension plan voting on a ballot item based on faith-based principles, and "AGAINST" to a client whose proxy voting policy focuses exclusively on maximizing shareholder value. Although as explained in more detail below, the SEC has opined that ***unsolicited*** proxy voting advice would constitute a "solicitation" under the Exchange Act proxy rules,[1] that opinion does not apply where the recipient of that advice has asked for personalized advice in the context of a fiduciary advisory relationship.

2. How ISS Formulates Proxy Voting Policies and Guidelines

ISS formulates its standard benchmark and specialty proxy voting policies and guidelines in a transparent manner. Each year, the policy-setting process begins with a Policy Survey seeking input from both institutional investors and corporate issuers (both executives and board members) in an effort to identify emerging issues that merit attention prior to the upcoming proxy season.[2] Based on this feedback, ISS convenes a series of roundtables with various industry groups and outside issue experts to gather multiple perspectives on complex or contentious issues. As part of this process, ISS examines academic literature, other empirical research and relevant commentary in an effort to uncover potential links between an issue and financial returns and/or risk. ISS also back tests any proposed changes to understand the possible impact of the various policy options being considered. Such impact assessments often lead ISS to phase-in new policies over a multi-year period to allow corporate issuers adequate time to prepare for any changes.

The ISS Global Policy Board, which is comprised of ISS' market research heads and internal subject-matter experts, uses this input to develop its draft policy updates. Before finalizing

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1 *See* Section B.4., *infra.*

2 In 2015, ISS received survey responses from more than 400 parties, including over 110 institutions and roughly 250 corporations. ISS' 2016 draft benchmark voting policies, meanwhile, solicited feedback from dozens of parties, including trade groups, such as the Society of Corporate Secretaries and Governance Professionals, the Center on Executive Compensation, the National Association of Corporate Directors, the National Association of Manufacturers, and the U.S. Chamber of Commerce.

these updates, ISS publishes them for an open review and comment period (modeled on the SEC's process for commenting on pending rule-making). This open comment period is designed to elicit objective, specific feedback from investors, corporate issuers and industry-constituents on the practical implementation of proposed policies. For the past several years, unless a commenter requests confidential treatment, all comments received by ISS have been posted *verbatim* to the ISS Policy Gateway on its public website, in order to provide additional transparency into the feedback ISS has received. Final updates are published in November to apply to meetings held after February of the following year.

A good example of how ISS' policy formation process works to address emerging issues stems from the implementation of the Dodd-Frank provision which provided shareholders with a non-binding advisory vote on compensation, and further allowed shareholders the ability to determine the frequency of such "Say on Pay" votes (whether annually, biannually or triennially). In developing ISS' policy framework for our initial vote recommendations on the frequency of these "Say on Pay" votes, ISS held many direct engagements with a diverse group of clients over a number of years which provided a clear investor preference for annual votes on the issue to promote transparency and communication with shareholders, and ISS also drew on the policies of umbrella organizations such as the Washington-based Council of Institutional Investors.

Once a company's shareholders had voted on the frequency to be set (which at most companies was voted on in 2011 and set the frequency for a 6-year period), ISS' policies thereafter looked to each company to respect the frequency supported by the majority of its shareholders, whether that was for a "Say On Pay" vote every three years, every two years or annually. For information, there is a long history of strong investor support for annual say-on-pay votes as a matter of good practice, and in 2011, shareholders gave majority support for annual frequency at approximately 80 percent of companies, and supported tri-annual frequency at approximately 17 percent of companies.

In addition to the Global Policy Board, ISS also has established a Feedback Review Board ("FRB"), which I chair, to provide an additional conduit for investors, executives, directors and other market constituents to communicate with ISS.

ISS' outreach is not confined to the policy-setting process. Robust engagement is an integral part of ISS' day-to-day operations. Each proxy season, ISS engages with thousands of corporate executives, board members, institutional investors and other constituents via in-person meetings, conference calls and participation in industry events. The purpose of such engagement is for ISS to obtain, or communicate, perspectives about governance and voting issues, in order to ensure that its research and policy-driven recommendations are based on the most comprehensive and accurate information available.

3. How the Proxy Advisory Process Works

Proxy season in the United States is concentrated primarily between mid-March and early June. This condensed schedule places enormous pressure on institutional investors, who may be called on to vote upwards of 25 - 30 meetings in a single day.[3] It also affects the process fiduciary advisers like ISS employ in producing proxy reports and formulating vote recommendations.

ISS collects and organizes data throughout the year on the roughly 39,000 public companies it tracks globally. When a proxy statement is issued -- typically four to six weeks before the shareholders meeting in the United States -- ISS assigns the statement to a member of its research and analytical team, which is organized by industry sector and subject-matter expertise (compensation or mergers/acquisitions, for example), who reviews the statement and begins to perform both quantitative and qualitative analyses on the issues presented. In the course of this process, ISS may communicate with issuers, investors and other interested parties; in contested situations, ISS routinely engages with both sides. Even in situations where ISS engages with

[3] Remarks of Michelle Edkins, Roundtable Transcript at 45.

interested parties, ISS relies only on publicly available information in preparing its research reports and making vote recommendations.

Once the review and analytical steps are complete, the analyst drafts the proxy research report. Insights gleaned from communications with interested parties are reflected in the reports if the analyst deems such information to be useful in helping institutional clients make more informed voting decisions. In some cases, ISS may include direct quotations from statements made by interested parties. At the discretion of the analyst, a brief "engagement summary" may be included as part of the analytical report.

ISS has adopted a number of policies and procedures designed to ensure the integrity of its research process. As noted above, ISS' analyses and recommendations are driven by publicly disclosed and detailed policy guidelines and public information about the relevant proxy issues, in order to ensure consistency and to eliminate potential analyst implementation bias. In addition, before being delivered to clients, each proxy analysis undergoes a rigorous internal review for factual accuracy and to ensure that the relevant voting policy has been properly applied.[4]

The entire analytical process, beginning with the receipt of the proxy statement, through the end of the internal review of the proxy report and vote recommendations, must be completed sufficiently in advance of the shareholder meeting to give the investor client adequate time to evaluate the report, conduct any additional analysis it deems necessary, engage with the issuer's executives and board members as needed, make a voting decision and process that decision for voting. In many cases, ISS has a contractual obligation to deliver proxy reports and vote recommendations to clients ten days to two weeks in advance of the meeting.

Despite this extremely tight timeframe, ISS has voluntarily incorporated a limited issuer review step into the analytical process. In the U.S., constituents of the Standard and Poor's 500

[4] ISS' commitment to quality is further demonstrated by the fact that it conducts periodic SSAE 16 audits to ensure compliance with its internal control processes, including its research process.

Index generally receive an opportunity to review a draft analysis for factual accuracy prior to the delivery of the report to clients, and ISS considers other requests for review and comments on a case-by-case basis. Given the limited time between the hard start of receiving the proxy statement and the hard stop of delivering the report to clients sufficiently in advance of the meeting, there simply is not time to afford all of the approximately 39,000 issuers ISS covers globally the opportunity to review draft reports. However, all issuers may receive a free copy of the published analysis for their own shareholder meetings upon request. This affords issuers the opportunity to bring any factual error in the report to ISS' attention. In many cases, however, what issuers consider to be "errors" are in fact differences in philosophy, interpretation or, simply, outright disagreements with ISS' voting policies.[5]

While ISS strives to be as accurate as possible, ISS' research team does, infrequently, identify material factual errors in research reports, such as those relating to the agenda, data or research/policy application. When this happens, or when ISS learns of a material factual error from the issuer or an investor, ISS promptly issues a "Proxy Alert" ("Alert") to inform clients of any corrections and, if necessary, any changes in the vote recommendations as result of those corrections or updates. Alerts are distributed to ISS' investor clients through the same ProxyExchange platform used to distribute the regular proxy analyses. This ensures that the clients who received an original analysis will also receive the related Alert, which is attached to the relevant company meeting.

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[5] Remarks of Anne Sheehan, Director of Corporate Governance, CalSTRS, Roundtable Transcript at 155 ("What I have found, that many times the errors are really differences of opinion").

B. The Regulatory Regime Governing Proxy Advisers

1. Applicability of the Advisers Act

More than seventy-five years ago, the Investment Advisers Act of 1940 ("Advisers Act") established a principles-based regulatory regime, the essence of which is the fiduciary relationship between an investment adviser and its clients. The statute defines the term "investment adviser" to mean any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities, or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports about securities.[6] This broad definition encompasses not only those who manage client portfolios, but also those who advise about ways to maximize the value of those portfolios.[7]

In its 2010 Concept Release on the U.S. Proxy System, the SEC confirmed the applicability of the Advisers Act to proxy advisers, saying:

> *[P]roxy advisory firms receive compensation for providing voting recommendations and analysis on matters submitted for a vote a shareholder meetings. . . . We understand that typically proxy advisory firms represent that they provide their clients with advice designed to enable institutional clients to maximize the value of their investments. In other words, proxy advisory firms provide analyses of shareholder proposals, director candidacies or corporate actions and provide advice concerning particular votes in a manner that is intended to assist their institutional clients in achieving their investment goals with respect to the voting securities they hold. In that way, proxy advisory firms meet the definition of investment adviser because they, for compensation, engage in the business of issuing reports or analyses concerning securities and providing advice to others as to the value of securities.*[8]

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[6] Advisers Act Section 202(a)(11) [15 USC 80b-2(a)(11)].

[7] Although the statute excludes from the definition of investment adviser a publisher of a bona fide newspaper or news magazine or business or financial publication of general and regular circulation, this exemption is unavailable to parties who tailor their publications to the needs of individual clients. *Lowe v. Securities and Exchange Commission,* 472 U.S. 181 (1985) (in order to qualify for the publisher's exemption, the publication must, among other things, provide *impersonal* advice, as opposed to advice tailored to the individual needs of the customer).

[8] Concept Release on the U.S. Proxy System ("Concept Release"), SEC Rel. No. IA-3052 at 109-110, 75 Fed. Reg. 42981, 43010 (July 22, 2010).

The SEC went on to explain the fiduciary implications of this characterization as follows:

> *The Supreme Court has construed Section 206 of the Advisers Act as establishing a federal fiduciary standard governing the conduct of investment advisers. The Court stated that '[t]he Advisers Act of 1940 reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship as well as a congressional intent to eliminate or at least to expose, all conflicts of interest which might incline an investment advisers -- consciously or unconsciously -- to render advice which was not disinterested.' As investment advisers, proxy advisory firms owe fiduciary duties to their advisory clients.*[9]

The SEC's views on the fiduciary status of proxy advisers align with the long-standing and recently confirmed views of the U.S. Department of Labor ("DOL") on this topic. In its Release announcing a final regulation defining who is a "fiduciary" of an employee benefit plan under the Employee Retirement Income Security Act of 1974 ("ERISA"), the DOL noted that it

> *has long viewed the exercise of ownership rights as a fiduciary responsibility because of its material effect on plan investment goals. 29 CFR 2509 08-2 (2008). Consequently, recommendations on the exercise of proxy or other ownership rights are appropriately treated as fiduciary in nature.*[10]

2. General Requirements of the Advisers Act

a. Registration

The Advisers Act and the rules adopted thereunder regulate virtually every aspect of an investment adviser's business. This regime starts with a formal SEC registration process that includes the filing of detailed information about the registrant's business practices, fees, clients, and conflicts of interest, including those arising from affiliated industry activities.[11] Once registration is granted, the registration form is uploaded into the Investment Adviser Public Disclosure ("IAPD") database, where the public can access it online through the SEC's website. On an ongoing basis,

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9 *Id.* at 110 *(internal citations omitted), quoting SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191-192 (1963).

10 DOL, Employee Benefits Security Administration, *Definition of the Term "Fiduciary"; Conflict of Interest Rule - Retirement Investment Advice*, RIN 1210-AB32, Final Rule (April 1, 2016) at 77-78, 80 Fed. Reg. 21928, 21939 (April 20, 2016).

11 Advisers Act § 203, SEC Rule 203-1 and Form ADV.

investment advisers are required to file interim updates of any material changes to their registration information, and within 90 days of the end of each fiscal year, advisers must report any other changes to their information and must certify that their registration forms are accurate and complete. All of these additional filings are also available to the public through the IAPD.

b. Brochure Disclosure

Even though clients can access an adviser's disclosure information through the IAPD, the Advisers Act still requires advisers to distribute plain-English brochures to clients at or before the time the adviser enters into an advisory agreement with a client.[12] On an annual basis, an adviser whose brochure has materially changed since its last annual update must provide each client with either a new brochure, or a summary of material changes and an offer of a new brochure. Interim amendments must be given to clients under certain circumstances as well.

c. Insider Trading Program and Code of Ethics

The Advisers Act compels all registered investment advisers to establish, maintain and enforce written supervisory procedures designed to prevent firms and their employees from misusing material, nonpublic information they may learn in the course of their advisory activities.[13] Advisers typically combine this duty with a separate Advisers Act duty to establish, maintain and enforce formal codes of ethics.[14] Such codes must establish general standards of business conduct for employees, in order to "effectively convey to employees the value the advisory firm places on ethical conduct, and [to] challenge employees to live up not only to the letter of the law, but also to the ideals of the organization."[15] The codes of ethics also must require employees to

[12] Advisers Act Rule 204-3. This brochure is the same one used for Part 2A of Form ADV. All brochures must follow a standardized format, a requirement that is designed to allow investors to "comparison shop" among advisers.

[13] Advisers Act, § 204A.

[14] SEC Rule 204A-1.

[15] SEC Release No. IA-2256 (July 2, 2004), text accompanying note 8.

comply with applicable federal securities laws and to report violations of law or the firm's code of ethics to the firm's compliance staff.

A third major component of an adviser's code of ethics has to do with personal trading. Because advisers are paid to render disinterested advice, fiduciary concerns arise when an adviser or its employees have a personal stake in the subject of their advice.[16] The Advisers Act Code of Ethics rule, therefore, requires advisers to obtain personal trading records from certain categories of employees, so that the adviser can eliminate, or at least manage and disclose any trading-related conflicts of interest.

Finally, advisers must describe their codes of ethics in their Form ADV disclosure brochures and must offer to furnish clients and prospective clients with those codes upon request.

d. Comprehensive Compliance Programs

Another SEC rule under the Advisers Act requires registered investment advisers to establish comprehensive compliance programs.[17] In this regard, an adviser must (a) designate a chief compliance officer responsible for administering the compliance program; (b) implement and enforce written policies and procedures reasonably designed to prevent, detect and correct violations of the Advisers Act; and (c) review those policies and procedures at least annually to assess their adequacy and the effectiveness of their implementation. Under this rule, advisers are obliged to tailor their compliance programs to the regulatory and business risks posed by their particular advisory activities.

e. Recordkeeping

The Advisers Act imposes extensive recordkeeping requirements on registrants.[18] Among the types of records that an adviser must maintain for a minimum of five years are (1) those relating

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[16] This fiduciary concern is the exact *opposite* of proxy adviser critics' suggestion that proxy advisers should have "skin in the game." In fiduciary parlance, “skin in the game” means “conflict of interest.”

[17] SEC Rule 206(4)-7.

[18] SEC Rule 204-2.

to the adviser's internal affairs, including financial records; (2) compliance procedures and documents evidencing the adviser's annual testing of those procedures; (3) codes of ethics and employees' acknowledgements of the receipt thereof, as well as records of code violations and any actions taken as a result thereof; (4) documents relating in a general way to the adviser's customers, including advisory contracts; (5) advertisements and marketing materials; (6) records of specific recommendations made to clients; (7) records relating to proxy voting, as described more fully in Section 3 below; (8) documents relating to political contributions where the adviser provides services to certain government entities; and (9) personal trading records for employees with access to sensitive client information.

f. Miscellaneous Requirements

Other aspects of the Advisers Act regulatory regime address advertising and other client solicitation, client contracts and pay-to-play (political contributions related to clients and potential clients). This principles-based regime also governs areas such as social media and cybersecurity.

g. SEC Examinations

All research firms registered under the Advisers Act are subject to periodic examination by the SEC's Office of Compliance Inspections and Examinations ("OCIE"). Without weighing in on the larger debate regarding the funding and sufficiency of the SEC's investment adviser examination program, we note that in 2015, OCIE announced that proxy advisers would be one of the priorities of its National Exam Program:

> *We will examine select proxy advisory service firms, including how they make recommendations on proxy voting and how they disclose and mitigate potential conflicts of interest. We will also examine investment advisers' compliance with their fiduciary duty in voting proxies on behalf of investors.*[19]

ISS can state from experience that SEC exams are regular and robust.

[19] OCIE, *Examination Priorities for 2015* (January 13, 2015), *available at:* www.sec.gov/ocie.

3. The Treatment of Proxy Voting Under the Advisers Act

In addition to the general Advisers Act provisions described above, there also are special requirements for advisers who vote or render advice about clients' proxies. The fiduciary implications of proxy voting were first articulated not by the SEC, but by the DOL in 1988. In a letter to the Chairman of the Retirement Board of Avon Products (the "Avon Letter"), addressing proxy voting for employee benefits plans subject to ERISA, the DOL stated:

> *In general, the fiduciary act of managing plan assets which are shares of corporate stock would include the voting of proxies appurtenant to those shares of stock.*[20]

A year after the Avon Letter, the DOL issued a report on the proxy voting practices of investment managers of ERISA-covered plans.[21] In this report the Department advised that practices such as declining to vote proxies and blindly voting all proxies with management are inconsistent with the fiduciary responsibility provisions of ERISA.

The fiduciary implications of proxy voting were recognized by the SEC in 2002, when in the wake of Enron's unprecedented failure of corporate governance, then-SEC Chairman Harvey Pitt responded to a request for guidance concerning the duty of investment advisers to vote proxies on their clients' behalf. After noting the absence of direct regulation of this issue under the federal securities laws, Chairman Pitt went on to say:

> *We believe, however, that an investment adviser must exercise its responsibility to vote the shares of its clients in a manner that is consistent with the general antifraud provisions of the Advisers Act, as well as its fiduciary duties under federal and state law to act in the best interests of its clients.*[22]

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[20] Letter from Alan D. Lebowitz, Deputy Assistant Secretary to Mr. Helmuth Fandl, Chairman of the Retirement Board, Avon Products, Inc. (February 23, 1988), 1988 ERISA LEXIS 19, *5-6.

[21] Pension and Welfare Benefits Administration, U.S. Department of Labor, Proxy Project Report (March 2, 1989).

[22] Letter from Harvey Pitt, SEC Chairman to John M. Higgins, President, Ram Trust Services (February 12, 2002). *See also* Baue, Walter, "SEC Chair Calls Proxy Voting a Fiduciary Duty" (March 29, 2002) available at: www.socialfunds.com/news/article.cgi/808.html.

Chairman Pitt also noted the Commission's ongoing review of various requests and proposals to address conflicts and enhance disclosure of proxy voting practices under the federal securities laws.

After completing that review, the SEC in 2003 adopted new rules and rule amendments relating to proxy voting by registered investment advisers[23] and registered investment companies.[24] In so doing, the agency relied on long-established fiduciary standards. For example in adopting the Advisers Act rule, the SEC said:

> *The federal securities laws do not specifically address how an adviser must exercise its proxy voting authority for its clients. Under the Advisers Act, however, an adviser is a fiduciary that owes each of its clients duties of care and loyalty with respect to all services undertaken on the client's behalf, including proxy voting. The duty of care requires an adviser with proxy voting authority to monitor corporate events and to vote the proxies. To satisfy its duty of loyalty, the adviser must cast the proxy votes in a manner consistent with the best interest of its client and must not subrogate client interests to its own.*[25]

Advisers Act Rule 206(4)-6 applies these traditional fiduciary concepts by requiring registered investment advisers to adopt written policies and procedures reasonably designed to ensure that the adviser monitors corporate actions and votes client proxies in the clients' best interests. What the rule does *not* do is require investment advisers to vote *every* proxy, regardless of facts and circumstances. To begin with, the rule applies only to those advisers who have explicitly or implicitly assumed voting authority over their clients' portfolios. Many small advisers, in fact, disclaim such authority altogether. Even where an adviser assumes such authority, the obligation to vote any particular proxy depends on facts and circumstances. In the Commission's words:

> *We do not suggest that an adviser that fails to vote every proxy would necessarily violate its fiduciary obligations. There may even be times when refraining from voting a proxy is in the client's best interest, such as when the adviser determines that the cost of voting the proxy exceeds the expected benefit to the client. An adviser may*

[23] SEC Rule 206(4)-6.

[24] *See* Investment Company Act Rel. No. 25922(January 31, 2003), 68 Fed. Reg. 6564 (February 7, 2003).

[25] Advisers Act Rel. No. 2106 (January 31, 2003), 68 Fed. Reg. 6585, 6586 (Feb 7. 2003) ("Proxy Rule Release") (citations omitted).

> *not, however, ignore or be negligent in fulfilling the obligation it has assumed to vote client proxies.*[26]

In addition to requiring an adviser to adopt proxy voting policies and procedures, the rule also requires the adviser to describe those policies and procedures to clients, and to provide a copy of them upon a client's request. Finally, the rule obliges the adviser to tell clients how they can obtain information about how their securities were voted.

Because the fiduciary duty of loyalty requires advisers to act in their clients' best interests, the Commission, in adopting Rule 206(4)-6, paid special attention to the ways in which advisers could manage conflicts of interest that might arise in the proxy voting process:

> *Advisers today use various means of ensuring that proxy votes are voted in their clients' best interests and not affected by the advisers' conflicts of interest. An adviser that votes securities based on a pre-determined voting policy could demonstrate that its vote was not a product of a conflict of interest if the application of the policy to the matter presented to shareholders involved little discretion on the part of the adviser. Similarly, an 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. Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.*[27]

The Commission's recognition that advisers can mitigate conflicts of interest in proxy voting by seeking the advice of an independent third party was hardly radical, since the same approach is widely utilized in other areas of investment management. For example, at the SEC's 2013 Roundtable, one institutional investor explained that advisers may seek independent expert advice on portfolio valuation issues in order to make their valuation decisions "less subject to criticism."[28] In

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[26] Proxy Rule Release, 68 Fed. Reg. at 6587 (citations omitted).

[27] *Id.* 68 Fed. Reg. at 6588 (citations omitted).

[28] Remarks of Eric Komitee, Roundtable Transcript at 73 ("[I]f we have a conflict of interest potentially with respect to the valuation of a given position, we may go get advice from a third party valuation firm because we believe that the valuation decision we make will be less subject to criticism once we have looked to the

the same vein, the then-General Counsel of the Investment Advisers Association remarked that advisers frequently delegate aspects of their management duties to third parties, but when they do so, they retain ultimate fiduciary responsibility for selecting and monitoring those parties.[29]

4. SEC Staff Interpretive Guidance On the Advisers Act Proxy Rule

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Approximately a year after Rule 206(4)-6 was adopted, an unregistered proxy adviser sought guidance from the staff of the SEC's Division of Investment Management about the meaning of the term "independent third party" as used in the rule's adopting release. After generally discussing the types of conflicts an adviser could face in voting clients' proxies, the staff explained that a third party's independence depends on its relationship to the adviser.[30] An investment adviser that retains a third party to make proxy voting recommendations must take reasonable steps to verify that the third party is in fact independent of the adviser based on all of the relevant facts and circumstances.

However, the staff went on to explain that merely determining the independence of the third party is not enough. Because the investment adviser is a fiduciary, the adviser has a duty to scrutinize the independent third party's "competency to adequately analyze proxy issues" and to make "recommendations in an impartial manner and in the best interests of the adviser's clients."[31] The staff indicated that such due diligence is not a one-time exercise, but must be undertaken on an ongoing basis, for example, by a case-by-case evaluation of the third party's own conflicts of interest.

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expertise of a third party that is . . . intended to think about those issues").

[29] Remarks of Karen Barr, General Counsel, *Id.,* at 57 ("Outsourcing is perfectly acceptable. It's perfectly acceptable to delegate duties to a third party. Investment advisers do it all the time, They hire, for example, sub-advisers to manage parts of their portfolio's core asset management duties, but what advisers do is retain the ultimate fiduciary responsibility to select those third parties. . . and then [exercise ongoing] oversight . . ").

[30] Letter from Douglas Scheidt, Associate Director and Chief Counsel, SEC Division of Investment Management to Kent S. Hughes, Egan Jones Proxy Services (May 27, 2004).

[31] *Id.*

In a subsequent letter to ISS, the staff gave additional guidance on the type of due diligence an adviser must conduct to satisfy its fiduciary duty when seeking proxy voting advice from an independent third party. In this regard, the staff explained:

> *Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process. . . . An investment adviser should have a thorough understanding of the proxy voting firm's business and the nature of the conflicts of interest that the business presents, and should assess whether the firm's conflict procedures negate the conflicts.*[32]

The Staff also said that because a proxy advisory firm's business and/or conflict procedures could change over time, the investment adviser has a fiduciary duty to monitor the third-party service provider's independence on an ongoing basis.

The Staff's opinion that an acceptable due diligence process for engaging a proxy adviser might entail a comprehensive examination of the proxy advisory service's conflict of interest policies and procedures in lieu of evaluating their conflicts on a vote-by-vote basis comports with the macro-level analysis advisers undertake in conducting due diligence in other contexts.[33] For example, an adviser who mitigates its conflicts regarding portfolio valuation by relying on the expertise of an independent valuation service typically assesses the service's integrity and competence by examining the service's overall policies, procedures and operations, and not by

[32] Letter from Douglas Scheidt, to Mari-Anne Pisarri, Pickard and Djinis LLP, Counsel for Institutional Shareholder Services Inc., 2004 SEC No-Act. LEXIS 736 (September 15, 2004) at *4-5.

[33] *See* Lorna A. Schnase, *An Adviser's Duty to Supervise Sub-Advisers (and Other Advisers)* 18-22 (2012) (noting that initial due diligence of outsourced advisory services should include matters such as a review of the third party's compliance systems, code of ethics, internal procedures, Form ADV disclosures and other information about the party's qualifications to perform in the capacity contemplated. On an ongoing basis, due diligence could include quarterly or annual certifications of compliance with applicable laws and the third party's policies and procedures, periodic meetings with key personnel, confirmation of ADV disclosures and notification of material changes to information previously supplied).

evaluating its conflicts on a security-by-security or price-by-price basis.

Although the two Staff interpretive letters from 2004 were dry, routine administrative guidance regarding a new rule, in the past few years, as the debate over the proper role of shareholders in corporate governance has escalated, corporate lobbyists have created a mythology surrounding these letters in an attempt to deprive investment managers and other shareholder representatives of access to professional proxy voting advice. Grossly exaggerating the impact of the letters and distorting investors' traditional interpretation of them, these lobbyists have attempted to rewrite history by variously charging that the letters "created" the demand for ISS' services, and that the letters invite investment advisers to "outsource" or "offload" their fiduciary duties on to unaccountable third parties.

In order to dispel the myths, a copy of the 2004 letter from the SEC staff to ISS is attached to this Statement. ISS encourages members of this Subcommittee to read the letter carefully before taking the extraordinary step of directing the SEC to withdraw this fiduciary guidance, as the proposed legislation would do.

As you review this letter, note first of all that it is not a "no-action letter," since it does not relieve investment advisers from any of the duties imposed on them by the proxy rule. Consider, too, what investor representatives at the SEC Roundtable had to say about the effect of the Staff guidance. For example, the then-General Counsel of the Investment Advisers Association explained that the staff interpretive letters did not make it easier for investment advisers to rely on third-party proxy advice. In fact, they did just the opposite, by spelling out the extensive and ongoing due diligence required of advisers who use these services. She also observed that, "[IAA] members' experience is not that they've increased their use of proxy advisory firms because of the . . . letters. They've increased the use because of the complexity and number of votes."[34]

[34] Roundtable Transcript at 58.

Another shareholder representative at the Roundtable noted that with or without the Staff letters, advisers have a fiduciary duty to vote proxies as a matter of good corporate citizenship, and that relying on the assistance of outside parties is a common way of addressing conflicts of interest.[35]

The Staff's admonition that advisers who engage independent proxy advisers retain the fiduciary duty to vote their clients' proxies in the clients' best interests and must monitor and evaluate independent proxy services on an ongoing basis was entirely consistent with what the SEC itself said when it adopted the proxy rule:

> *Nothing in this rule reduces or alters any fiduciary obligation applicable to any investment adviser (or person associated [therewith].*[36]

And the SEC's statement echoed the position DOL took in the 1988 Avon Letter:

> *ERISA contains no provision which would relieve an investment manager of fiduciary liability for any decision he made at the direction of another person. . . Therefore, . . . to the extent that anyone purports to delegate to another the responsibility for such voting decisions, the manager would not be relieved of its own responsibilities and related liabilities merely because it either follows the direction of some other person or has delegated the responsibility to some other person.*[37]

The SEC and Staff warnings to the effect that hiring a proxy adviser is not a "safe harbor" from fiduciary duty had very practical consequences in a 2009 SEC enforcement action in which the Commission sanctioned a registered investment adviser for voting all of its clients' proxies in accordance with third-party proxy guidelines without ensuring that those guidelines were in the best interests of all of its clients.[38]

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35 Remarks of Eric Komitee, *Id.* at 72-75.

36 Proxy Rule Release, note 8.

37 Avon Letter, 1988 ERISA LEXIS 19,*8.

38 *In the Matter of INTECH Investment Management LLC and David E. Hurley,* Advisers Act Release No. 2872 (May 7, 2009). In finding a violation of Advisers Act Section 206 and Rule 206(4)-6, the Commission noted that the adviser's choice of voting guidelines was tainted by a conflict of interest, because the adviser chose guidelines that could help it retain and obtain advisory business notwithstanding the fact that those guidelines were unsuitable for certain clients.

As for the notion that the Staff interpretive letters created the market for ISS' services, I can attest that by the time the SEC adopted the proxy rule in 2003 and the Staff issued guidance on that rule in 2004, ISS was already already established as the leading provider of reliable, comprehensive proxy research and voting recommendations. Notably, while the SEC did not adopt its formal rules until 2003, numerous favorable comments about the DOL's guidance from Commission officials over the years had led many industry players to describe the Staff's view of proxy voting duties as "creeping ERISA." Because most of ISS' clientele long predates the SEC's involvement in fiduciary proxy regulation, I can say with confidence that ISS' success has been driven more by a dedication to meeting investor needs than it has been by any action taken by the SEC.

-- Staff Legal Bulletin 20

A decade after the Staff issued its interpretive letters on the proxy rule and in the midst of all the noise from corporate interests about what the rule and the interpretive guidance really mean, the Staff of the SEC's Investment Management Division and the Staff of the Corporation Finance Division issued a joint communiqué (Staff Legal Bulletin No. 20 or SLB 20) about proxy voting.[39] In the first part of this document, the Investment Management Staff revisited the topic of fiduciary duty and proxy voting under the Advisers Act. In so doing, the Staff confirmed what the Commission said in the rule's adopting release, namely that advisers have no absolute duty to vote every proxy relating to their clients' portfolios.[40] Instead, the Staff said, advisers and their clients have the flexibility to determine the scope of the adviser's duty to exercise proxy voting authority, which may be limited by time and cost considerations or the type of issue presented.

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[39] SEC Division of Investment Management, Division of Corporation Finance, *Proxy Voting: Proxy Voting Responsibilities of Investment Advisers and Availability of Exemptions from the Proxy Rules for Proxy Advisory Firms,* Staff Legal bulletin No. 20 (IM/CF) June 30 2014, *available at* http://www.sec.gov/interps/legal/cfslb20.htm (hereafter, "SLB 20").

[40] *See* note 52, *supra. a*nd accompanying text.

The Staff also confirmed the guidance it provided in the 2004 interpretive letters to the effect that an investment adviser who retains an independent proxy adviser has a fiduciary duty to conduct reasonable due diligence to ascertain whether that proxy adviser has the capacity and competency to adequately analyze proxy issues, and sufficient policies and procedures to identify and address conflicts of interest. As it did in 2004, the Staff emphasized that these due diligence obligations exist not just at the time the proxy adviser is engaged, but throughout the life of the engagement.

Finally, the Staff provided guidance on ways in which investment advisers could confirm that their clients' proxies are being voted in accordance with clients' best interests and with the adviser's proxy voting procedures, such as by periodically sampling votes cast. The Staff also reminded advisers of their duty to at least annually assess the sufficiency of their own proxy voting policies and procedures and the effectiveness of the implementation of those policies and procedures, as required by Advisers Act Rule 206(4)-7.

In the second part of SLB 20, the Staff of the SEC's Division of Corporation Finance addressed the interplay between proxy advisory services and the federal proxy rules under section 14 of the Exchange Act. Noting that Exchange Act Rule 14a-1(l) defines a proxy solicitation to include "the furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy," the Staff summarized a long-standing Commission position as follows: "As a general matter, the Commission has stated that the furnishing of proxy voting advice constitutes a 'solicitation' subject to the information and filing requirements of the federal proxy rules."[41] As noted above, however, what the SEC actually said in the Release the staff purports to rely on is, "As a general

[41] SLB 20, note 10, *citing Shareholder Communications, Shareholder Participation in the Corporate Electoral Process and Corporate Governance Generally,* SEC Release No. 34-16104 (August 13, 1979).

matter, ***unsolicited*** proxy voting advice would constitute a 'solicitation' subject to the proxy rules."[42] This critical omission changes the entire meaning of the SEC's long-standing position, and, in ISS' view, confirms that proxy advisers who supply proxy voting advice based on investor-selected voting guidelines in the context of a fiduciary advisory relationship are not engaged in a 'solicitation" as contemplated by Section 14 of the Exchange Act.

After addressing the definition of "solicitation," the Staff went on in SLB-20 to confirm that proxy advisers who furnish advice in the ordinary course of business, and disclose to the recipient of their advice any significant relationship they have with the subject of the advice or its affiliates, or a security holder proponent of the matter on which advice is given, and who satisfy certain other conditions, are exempt from the information and filing requirements of the Exchange Act proxy rules. The Staff also furnished guidance on how a proxy advisory firm could make the facts-and-circumstances determination of whether it had a significant relationship with a company or a security holder proponent, or whether it otherwise had a material interest in the matter that is the subject of the voting recommendation.

C. ISS' Compliance With The Advisers Act Regulatory Regime And Mitigation of Conflicts of Interest

As a registered investment adviser since 1997, ISS complies with the regulatory reporting, client disclosure, insider trading, code of ethics, compliance procedures, recordkeeping, advertising, pay-to-play and other aspects of the Advisers Act regime applicable to investment advisers who

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[42] *Id.* The Commission's statement In Release No. 34-16104 is consistent with the prior position of the SEC's General Counsel announced in SEC Release No. 34-7208 (January 7, 1964). That earlier Release addressing when proxy voting advice by a broker-dealer could be subject to the federal proxy rules said:

> *In our view a broker normally is not engaged in solicitation where he merely responds, whether orally or in writing, to an* ***unsolicited*** *request from a customer for advice as to how to vote. Since the broker is merely responding to his customer's request for advice in his capacity as adviser to the customer and is not actively initiating the communication, it may be concluded that he is not engaged in 'soliciting.'*

supply research to investors. At the heart of its regulatory compliance program is a deliberate, carefully crafted, routinely tested and periodically updated series of measures designed to eliminate, or manage and disclose conflicts of interest.

ISS addresses conflicts, first and foremost, by being a transparent, policy-based organization. Its use of a series of published voting policies provides a very practical check and balance that ensures the integrity and independence of ISS' analyses and vote recommendations. While these policies allow analysts to consider company- and market-specific factors in generating vote recommendations, the existence of a published analytical framework, coupled with the fact that vote recommendations are based on publicly-available information, allows ISS clients to continuously monitor the integrity and consistency of ISS advice.[43]

Furthermore, as required by the Advisers Act's compliance program rule,[44] ISS has undertaken a comprehensive risk assessment to identify specific conflicts of interest related to its operations and has adopted compliance controls reasonably designed to manage those risks. One of the primary components of its compliance program is its Code of Ethics, which as required by SEC Rule 204A-1, prescribes standards of conduct for ISS and its employees.[45]

The Code of Ethics affirms ISS' fiduciary relationship with its clients and obligates ISS and its employees to carry out their duties solely in the best interests of clients and free from any compromising influences and loyalties. The Code also contains restrictions on personal trading designed to prevent employees from improperly trading on, or benefiting from, inside information, client information and/or ISS's voting recommendations. The Code emphasizes the requirement that all research for clients be rendered independently of employees' personal interests.

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[43] Each ISS analysis includes a URL for a direct hyperlink to ISS' summary voting guidelines for easy access by users of ISS research.

[44] SEC Rule 206

[45] *See* discussion at Section B.2.c., *supra.*

In order to ensure compliance with the Code of Ethics, ISS conducts periodic training sessions for employees and requires employees to affirm their commitment to compliance on an annual basis. Furthermore, ISS regularly monitors the sufficiency of the Code and the effectiveness of its implementation.

1. Conflicts in Connection with Affiliated Corporate Services

The most talked-about conflict where ISS is concerned relates to the fact that one of its subsidiaries, ISS Corporate Solutions, Inc. ("ICS"), provides governance tools and services to corporate issuer clients. Left unchecked, this conflict could result in vote recommendations that are biased in favor of corporate management. However, the fact that the most vocal critics of ISS are those who speak on behalf of corporate management (like several of the witnesses at today's hearing), and not the investors who rely on ISS' research and vote recommendations, indicates that ISS is managing the potential of this conflict extremely well.

One of the most important components of the ISS compliance program is the firewall maintained between the core institutional business and the ICS business. This firewall includes the physical and functional separation between ICS and ISS, with a particular focus on the separation of ICS from the ISS Global Research team. A key goal of the firewall is to keep the ISS Global Research team from learning the identity of ICS' clients, thereby ensuring the objectivity and independence of ISS' research process and vote recommendations. The firewall mitigates potential conflicts via several layers of separation:

- ICS is a separate legal entity from ISS.
- ICS is physically separated from ISS, and its day-to-day operations are separately managed.
- ISS Global Research team works independently from ICS.
- ICS and ISS staff are forbidden to discuss the identity of ICS clients.
- Institutional analysts' salaries, bonuses and other forms of compensation are not linked to any specific ICS activity or sale.
- ICS explicitly tells its corporate clients and indicates in their contracts that ISS will not give preferential treatment to, and is under no obligation to support, any proxy proposal of an ICS client. ICS further informs its clients that ISS' Global Research team prepares its analyses and vote recommendations independently of, and with no

involvement from, ICS.

As is the case with the Code of Ethics, ISS maintains a robust training and monitoring program regarding the firewall. This program includes quarterly tests of the firewall's integrity, new-hire orientation, and review of certain marketing materials and disclosures. There also is an ethics hotline available to both ICS and ISS staff for reporting issues of potential concern.

2. Conflicts in Connection with ISS' Owner

ISS is a privately-held company, whose ultimate owner is affiliated with Vestar Capital Partners, a private equity firm. ISS has complete independence from its owner in the application of its voting policies, the preparation of proxy analyses and the formulation of vote recommendations. The Board of Directors of ISS has formally adopted a Policy on Mitigation of Potential Conflicts of Interest. Among other things, this Policy is intended to identify situations that may exist or give rise to actual or potential conflicts of interest, or to the appearance of conflicts of interest, in connection with the work that ISS performs in researching, analyzing and making recommendations regarding publicly-held companies relative to the work of Vestar as a private equity firm, and to take such actions as may be necessary to mitigate any actual or potential conflicts.

3. Conflicts Within the Institutional Advisory Business

Conflicts also may arise where an ISS client is, itself, a public company whose proxies are the subject of analyses and voting recommendations, or other advisory research reports or where the Company is called upon to analyze and vote on shareholder proposals propounded by a Company client. ISS' fiduciary commitment to act in the best interests of each client, its practice of aligning vote recommendations with applicable published or custom voting policies, and the ongoing scrutiny it receives from its institutional clientele effectively address this potential conflict.

4. Conflicts in Connection with Issuers' Review of Draft Analyses

Allowing issuers to review draft proxy research reports presents a risk that the subjects of

ISS' advice will have an undue influence on the content of that advice. In order to ensure the propriety of the interaction between the issuer and the analyst, any decision by an analyst to change a vote recommendation based on an issuer's notification of one or more factual errors in a draft report must be reviewed by a senior analyst and appropriate records must be kept of the communication from the issuer and the voting decision. These records are subject to the Chief Compliance Officer's periodic review.

5. Disclosure Regarding Potential Conflicts

ISS provides its investor clients with an extensive array of information to ensure that they are fully informed of potential conflicts and the steps ISS has taken to address them. In addition to making full disclosure in the Form ADV brochure it delivers to each client, ISS supplies a comprehensive due diligence compliance package on its web site to assist clients and prospective clients in fulfilling their own obligations regarding the use of proxy advisory services. This package includes a copy of ISS' Code of Ethics, a description of other policies, procedures and practices regarding potential conflicts of interest and a description of the ICS business. A copy of the ISS Board of Directors Conflicts of Interest Policy related to Director-Affiliated Companies is also available through the ISS web site.

Moreover, each proxy analysis and research report ISS issues contains a legend indicating that the subject of the analysis or report may be a client of or affiliated with a client of ISS, ICS or another ISS subsidiary. Each analysis and report also notes that one or more proponents of a shareholder proposal may be a client of ISS or one of its affiliates, or may be affiliated with such a party. Although investment advisers typically disclose conflict of interest information at a macro level,[46] ISS does more. Any institutional client that wishes to learn more about the relationship, if any, between ICS and the subject of a particular analysis or report may contact ISS' Legal and

[46] *See, e.g.* Form ADV, Part 2A, Item 11.

Compliance Department for relevant details. This process allows ISS' proxy voting clients to receive the names of ICS clients without revealing that information to research analysts as they prepare vote recommendations and other research. ISS clients are also provided with details about the amount that each ICS client has paid ICS and the particular products/services they purchased. Were the ICS relationship identified on the face of a proxy analysis or report, this critical information barrier would be destroyed.

In addition to obtaining report-by-report conflict information, institutional clients of ISS can obtain lists of all ICS clients. Some clients receive such lists on a monthly basis, while others receive the lists on a quarterly or annual basis. This is just one of the many steps institutional investors take to reassure themselves that ISS is appropriately mitigating conflicts. They also obtain a range of additional information regarding our information barriers, our data centers, and other aspects of our operations. Many clients meet with ISS staff on an annual basis to discuss conflicts and other due diligence matters.

-- ISS' Response to SLB 20

ISS' response to SLB-20 was two-fold. With regard to the first portion of SLB-20 that reminded investment advisers of the SEC's long-standing position that advisers must exercise appropriate oversight of their third-party proxy advisory firms, ISS reviewed and updated its due diligence materials to provide its clients with the information they need to fulfill that oversight responsibility. Through the materials that ISS makes available online, the facilitation of due diligence meetings and calls with clients and other communication avenues, ISS provides clients with detailed information regarding the capabilities of ISS staff, our capacity to analyze proxy issues, and our ability to formulate voting recommendations in an impartial and accurate manner.

Although ISS does not agree with the Corporate Finance Staff's view that personalized, fiduciary proxy advisory services acquired by institutional investors are "solicitations" under the Exchange Act proxy rules, ISS nevertheless took steps to assess potential conflicts of interest arising from certain types of significant relationships and then improved the manner in which those relationships are disclosed. To this end, ISS' executive leadership team, in conjunction with ISS' Legal/Compliance team, designed and published in November 2014 a *Policy Regarding Disclosure of Significant Relationships.* This Policy provides our clients with a firm understanding of how we assess and disclose any significant relationships that may exist between ISS and the subjects of our proxy research reports. At the time we published this Policy, we also enhanced our client-facing ProxyExchange platform to provide these disclosures to our clients in a way that both protects the firewall between ISS and ICS seamlessly integrates the disclosure with our clients' workflows.

Investment Advisors Act of 1940 - Rule 206(4)-6
Institutional Shareholder Services, Inc.

September 15, 2004

Mari Anne Pisarri, Esq.
Pickard and Djinis LLP
1990 M Street, N.W.
Washington, DC 20036

Dear Ms. Pisarri:

In your letter dated September 15, 2004 on behalf of Institutional Shareholder Services, Inc. ("ISS"), you request that we elaborate on the guidance that we provided on May 27, 2004 to Egan Jones Proxy Services (the "Egan Jones Letter") concerning investment advisers that use the recommendations of independent third parties to vote client proxies.[1] You essentially request that we concur with your view that an investment adviser may determine that a proxy voting firm is capable of making impartial proxy voting recommendations in the best interests of the adviser's clients based on the procedures that the proxy voting firm has adopted and implemented to insulate the firm's voting recommendations from incentives to vote the proxies to further the firm's relationships with issuers ("conflict procedures").[2]

In the Egan Jones Letter, we indicated that, under certain circumstances, a proxy voting firm could be an independent third party for purposes of making proxy voting recommendations for an investment adviser's clients, even though the firm receives compensation from an issuer ("Issuer") for providing advice on corporate governance issues ("corporate services").[3] We explained, however, that an investment adviser could breach its fiduciary duty of care to its clients by voting its clients' proxies based upon a proxy voting firm's recommendations because the firm could recommend that the adviser vote the Issuer's proxies in the firm's own interests, to further its relationship with the Issuer and its business of providing corporate services, rather than in the interests of the adviser's clients.

In the Egan-Jones Letter, we stated that an investment adviser should obtain information from any prospective proxy voting firm to enable the adviser to determine that the firm is in fact independent, and can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. We suggested that an investment adviser also obtain such information on an ongoing basis from any proxy voting firm that it employs. We also suggested that an investment adviser require a proxy voting firm to disclose to the adviser any relevant facts concerning the firm's relationship with an Issuer, such as the amount of the compensation that the firm has received or will receive from the Issuer.

You contend that a case-by-case evaluation of a proxy voting firm's potential conflicts of interest is not the exclusive means by which an investment adviser may fulfill its fiduciary duty of care to its clients in connection with voting client proxies according to the firm's recommendations. We agree. You believe that an investment adviser may instead determine that a proxy voting firm is capable of making impartial recommendations in the best interests of the adviser's clients based on the firm's conflict procedures.

Whether an investment adviser breaches or fulfills its fiduciary duty of care when employing a proxy voting firm depends upon all of the relevant facts and circumstances. Consistent with its fiduciary duty, an investment adviser should take reasonable steps to ensure that, among other things, the firm can make recommendations for voting proxies in an impartial manner and in the best interests of the adviser's clients. Those steps may include a case by case evaluation of the proxy voting firm's relationships with Issuers, a thorough review of the proxy voting firm's conflict procedures and the effectiveness of their implementation, and/or other means reasonably designed to ensure the integrity of the proxy voting process.

The relevant facts and circumstances will dictate what steps an investment adviser should take in evaluating a prospective proxy voting firm.

When reviewing a proxy voting firm's conflict procedures, an investment adviser should assess the adequacy of those procedures in light of the particular conflicts of interest that the firm faces in making voting recommendations.[4] An investment adviser should have a thorough understanding of the proxy voting firm's business and the nature of the conflicts of interest that the business presents, and should assess whether the firm's conflict procedures negate the conflicts.[5] The investment adviser should also assess whether the proxy voting firm has fully implemented the conflict procedures.

We also note that a proxy voting firm's business and/or conflict procedures could change after an investment adviser's initial assessment, and any changes could alter the effectiveness of the conflict procedures and require the adviser to make a subsequent assessment. Consequently, an investment adviser should establish and implement measures reasonably designed to identify and address the proxy voting firm's conflicts that can arise on an ongoing basis, such as by requiring the firm to update the adviser of any relevant change in its business or conflict procedures.

Please note that we take no position in this letter regarding whether ISS' conflict procedures, as described in your letter, effectively ensure that its proxy voting recommendations to investment advisers are impartial. Nor do we take any position regarding whether an investment adviser should hire ISS as an independent third party to vote client proxies. The decision to hire ISS as an independent third party and, in particular, the assessment of the adequacy and effectiveness of ISS' conflict procedures rests entirely with the investment adviser. If you have additional questions, you may telephone John L. Sullivan, Senior Counsel, David W. Grim, Branch Chief, or Alison M. Fuller, Assistant Chief Counsel, at (202) 942-0659.

Very truly yours,

Douglas Scheidt
Associate Director and
Chief Counsel

Endnotes

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[1] As we noted in the Egan-Jones Letter, an investment adviser may face direct and indirect conflicts of interest in voting its clients' proxies. An investment adviser could, however, demonstrate that its vote of its clients' proxies was not a product of a conflict of interest if the adviser voted the proxies in accordance with a pre-determined policy based on the recommendations of an independent third party. See Investment Advisers Act Release No. 2106 (Jan. 31, 2003) (adopting Rule 206(4) 6). See also Investment Company Act Release No. 25922 (Jan. 31, 2003) (adopting Rule 30b1-4 under the Investment Company Act of 1940).

[2] In your letter, you specifically request no-action relief under rule 206(4)-6 under the Advisers Act. That rule addresses the adoption, implementation and disclosure of proxy voting procedures that are reasonably designed to ensure that investment advisers vote client proxies in their clients' best interests. You do not, however, request relief from any requirement of the rule. Consequently, we will not respond to your request for no-action relief under the rule. In addition, as a matter of policy, we will not respond to inquiries as to whether any particular policies and procedures are reasonably designed to ensure that an investment adviser votes its clients' proxies in their best interest because those inquiries are factual in nature, and we are not in a position to ascertain, verify or evaluate the requisite factual information.

[3] We stated that the mere fact that the proxy voting firm provides corporate services and receives compensation from the Issuer for these services generally would not affect the firm's independence from an investment adviser for purposes of making voting recommendations concerning the Issuer's proxies for the investment adviser's clients.

[4] For example, when assessing a proxy voting firm's conflict procedures, an investment adviser should consider whether the procedures effectively (a) preclude the natural persons who make the firm's proxy voting

recommendations from obtaining access to information about the firm's business relationships with Issuers and (b) insulate those persons from direct or indirect influence by the firm's employees who know of those relationships.

In addition, an investment adviser should consider, among other things, evaluating the frequency with which the proxy voting firm recommends voting in favor of the management of Issuers that have engaged the firm to provide corporate services.

[5] As an example, an investment adviser should consider how the conflict procedures address a proxy voting firm's voting recommendation concerning an Issuer that makes payments to the firm for corporate services, which are the single largest source of revenue for the firm.

Incoming Letter

Pickard and Djinis LLP
Attorneys at Law
1990 M Street, N.W.
Washington, D.C. 20036

September 15, 2004

By Hand and Electronic Mail

Douglas J. Scheidt, Esq.
Associate Director (Chief Counsel)
Division of Investment Management
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Mr. Scheidt:

We submit this letter on behalf of Institutional Shareholder Services, Inc. ("ISS") to request assurance that the Division of Investment Management will not recommend enforcement action to the Commission if a registered investment adviser determines the impartiality of an independent proxy voting firm based on the proxy voting firm's overall policies and procedures rather than on an examination of the firm's specific relationships with individual issuers. In particular, ISS seeks a no-action position to the effect that an adviser may satisfy its duty under Rule 206(4)-6 under the Investment Advisers Act of 1940 ("Advisers Act") to determine that an independent proxy voting firm is capable of making impartial recommendations in the best interests of the adviser's clients by examining the procedures that the proxy voting firm has adopted to insulate its voting recommendations from its relationships with issuers.

ISS is a registered investment adviser whose primary business is helping institutional investors meet their fiduciary responsibilities related to proxy voting. It does this by analyzing proxies and issuing informed research and objective vote recommendations for more than 10,000 U.S. and 12,000 non-U.S. shareholder meetings each year.[1] In addition, the company publishes proxy voting manuals, newsletters and proxy season reviews, and maintains various corporate governance databases.

Completely separate from its institutional business, ISS also serves the issuer community with a variety of corporate governance web-based tools, advisory services and publications that can assist issuers with executive and director compensation modeling, capital structure planning and understanding corporate governance best practices. ISS believes that supplying issuers with access to its corporate governance web-based tools, advisory services and publications benefits the firm's institutional clientele, because good corporate governance ultimately results in increased shareholder value. Nevertheless, ISS realizes that serving both institutional investors and issuers could create potential conflicts. ISS has adopted and follows policies and procedures to ensure that the proxy voting advice and services it provides to institutional investors remain independent from the products and services it offers to issuers. These policies and procedures are fully disclosed to ISS' clients.

First, ISS has erected a firewall between its institutional and corporate activities in order to maintain the highest level of objectivity in research and integrity in voting recommendations. This firewall involves functional, physical, and technological separations. For example, the management and staff of the Domestic and Global Research departments who analyze proxies and formulate voting recommendations are completely different from the management and staff of the Corporate Programs division who supply the web-based tools and publications to corporate clients and provide advice in connection therewith. The sales staffs for the institutional and corporate products are distinct as well.

The Domestic and Global Research staff and the Corporate Programs staff operate out of separate and secure areas at ISS' headquarters, and they maintain separate and secure office equipment and information databases. Furthermore, both the Corporate Programs staff and the sales staff for the corporate products have been trained in the requirement to keep the identities of the issuer clients confidential, and they communicate with those clients in a secure fashion. ISS has also instituted a "blackout" policy pursuant to which the Corporate Programs division refrains from providing any advisory services to issuers or access to the web-based tools from the time a definitive proxy statement is filed and until the date of the issuer's shareholders' meeting.

In addition to its elaborate firewall, ISS has taken other steps to ensure the objectivity and transparency of its proxy voting advice. For example, ISS publishes a Proxy Voting Manual that describes all of the company's policies and the analytical framework it uses to make voting decisions on every major issue. By articulating these policies and analytical framework and requiring that all proxy analyses and vote recommendations be formulated in accordance therewith, the Manual ensures that each individual proxy analysis and voting recommendation is made on an objective basis. Furthermore, ISS requires issuers who buy products and services from the Corporate Programs division to sign an agreement acknowledging that their acquisition of such services will not result in their proxy proposals' receiving preferential treatment from ISS.[2]

Believing that sunlight is the best disinfectant, ISS also informs its institutional clientele about its business relationships with issuers in a number of different ways. For example, Part II of ISS' Form ADV contains a comprehensive narrative description of all the products and services that ISS makes available to corporations. Similar comprehensive disclosure appears on ISS' website.[3] In addition, the standard Master Services Agreement ISS uses with its institutional clients clearly discloses both that ISS' Corporate Programs Division offers products and services to issuers of proxy solicitations and that the Corporate Programs Division employees are not involved in the analysis of filed proxy proposals or the preparation of vote recommendations.

Finally, ISS discloses the existence of its corporate relationships on each proxy analysis, and it does so in a way that protects the sanctity of the firewall:

> *This issuer may have purchased self-assessment tools and publications from ISS, or ISS's Corporate Programs Division may have provided advisory or analytical services to the issuer in connection with the proxies described in this report. Neither the issuer nor any Corporate Programs Division employee played a role in the preparation of this report. To inquire about any issuer's use of ISS Corporate Programs products please email disclosure@issproxy.com.*

ISS affords institutional subscribers the opportunity to inquire about ISS' specific relationship with any individual issuer rather than merely publishing that information, because publicly identifying corporate clients would tip off the proxy analyst as to those relationships, thereby raising the very conflict that the company's information barrier is designed to avoid.

For the reasons discussed below, we respectfully submit that an adviser who subscribes to ISS' Proxy Advisory Services could sufficiently assess ISS' ability to render impartial voting advice on the basis of the firewall, general disclosure and other policies and procedures described herein without inquiring about specific issuer relationships on a case-by-case basis.

DISCUSSION AND ANALYSIS

As fiduciaries, investment advisers owe their clients duties of care and loyalty regarding all activities they undertake on their clients' behalf.[4] Last year, the Commission adopted Rule 206(4)-6 under the Advisers Act to address advisers' fiduciary duties in the context of proxy voting.[5] Among other things, this rule requires an investment adviser who has authority to vote client proxies to adopt and implement written policies and procedures reasonably designed to ensure that the adviser votes those proxies in the clients' best interest.[6]

The required policies and procedures must specifically describe how the adviser addresses material conflicts between its interests and those of its clients with respect to proxy voting. However the rule does not dictate the way in which advisers must address conflicts; nor does it include a list of approved procedures. Instead, the Commission recognized that because advisers come in so many shapes and sizes, the public is best served if advisers have the flexibility to craft procedures tailored to their operations and the particular conflicts they face.

While declining to specify how an adviser must address conflicts of interest, the Commission, in the Adopting Release for the rule, did discuss a number of options an adviser might consider. These include disclosing conflicts and obtaining client consent before voting; having the client engage another party to vote a proxy involving a material conflict; voting securities based on a pre-determined policy, where application of that policy to the matter in question leaves the adviser little discretion; or voting in accordance with a pre-determined policy based on the recommendations of an independent third party. To these options, the Commission added:

> *Other policies and procedures are also available; their effectiveness (and the effectiveness of any policies and procedures) will turn on how well they insulate the decision on how to vote client proxies from the conflict.*[7]

In a May 27, 2004 interpretive letter to Egan-Jones Proxy Services the staff of the Investment Management Division addressed the circumstances under which a third party may be considered "independent" for purposes of Rule 206(4)-6. In particular, the Egan-Jones letter confirmed that a third-party voting service's independence is determined by its relationship to the adviser who hires it to vote client proxies, not by its other business relationships. Thus, the "mere fact that the proxy voting firm provides advice on corporate governance issues and receives compensation from the Issuer for these services generally would not affect the firm's independence" for purposes of Rule 206(4)-6.[8]

However, the interpretive letter went on to explain that in order to satisfy its fiduciary duties, an investment adviser must undertake some due diligence before deciding to follow the voting recommendations of an independent proxy voting firm. In this regard, the adviser must obtain sufficient information to determine, among other things, that the independent voting firm has the capacity and competency to analyze proxy issues adequately, and that it is capable of making voting recommendations in an impartial manner and in the best interest of the adviser's clients. The adviser should also implement procedures to identify and address any conflicts regarding the third-party voting service that can arise on an ongoing basis.

Where an independent voting agent receives compensation from issuers for providing advice on corporate governance matters, the letter suggests various steps an investment adviser could take to ascertain that the agent is still able to make impartial voting recommendations in the best interests of the adviser's clients. These steps include requiring the voting agent to disclose information about its corporate governance activities on an issuer-by-issuer basis, or allowing the independent third party to vote the proxies of only those issuers with whom it has no material relationship. Although the staff did not indicate that these steps were the exclusive means by which an investment adviser could satisfy its fiduciary duties to its clients, some parties have, unfortunately, read the Egan-Jones letter that way.

As noted above, in adopting Rule 206(4)-6 the Commission opined that an adviser can address conflicts of interest in a variety of ways, and that the effectiveness of an adviser's policies and procedures depends on how well they insulate the proxy voting decision from the conflict in question. This means that an adviser can make a determination of an independent proxy voting agent's ability to render impartial advice based on the independent proxy voting agent's policies and procedures to insulate its voting recommendations from its relationships with issuers, without inquiring about the firm's relationships with issuers on a case-by-case basis.

CONCLUSION

Based upon the foregoing, we ask for your assurance that you will not recommend that the Commission take enforcement action for a violation of Rule 206(4)-2 under the Advisers Act if a registered investment adviser determines the impartiality of an independent proxy voting firm based on the proxy voting firm's overall policies and procedures rather than on an examination of the proxy voting firm's specific relationships with individual issuers. If you need any further information on this matter, please do not hesitate to contact me or William D. Edick at 202-223-4418.

Very truly yours,

Mari-Anne Pisarri

cc: John M. Connolly

Endnotes

[1] ISS also votes, records and generates voting activity reports for approximately one-half of its institutional shareholder client base.

[2] In fact, approximately 25 percent of all issuers who use ISS' products or services subsequently submit proposals that receive a negative recommendation from ISS' Proxy Advisory Service.

[3] www.issproxy.com. The home page for this site clearly identifies "Solutions for Institutional Investors" and "Solutions for Corporate Issuers."

[4] See SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

[5] See IA Rel. No. 2106 (Jan. 31, 2003) (the "Adopting Release").

[6] The rule also obligates advisers to disclose information about those policies and procedures to clients and to inform clients how they can obtain information regarding how the adviser has voted their proxies.

[7] Adopting Release at section II.A.2.b.

[8] Egan-Jones Proxy Services at 3.